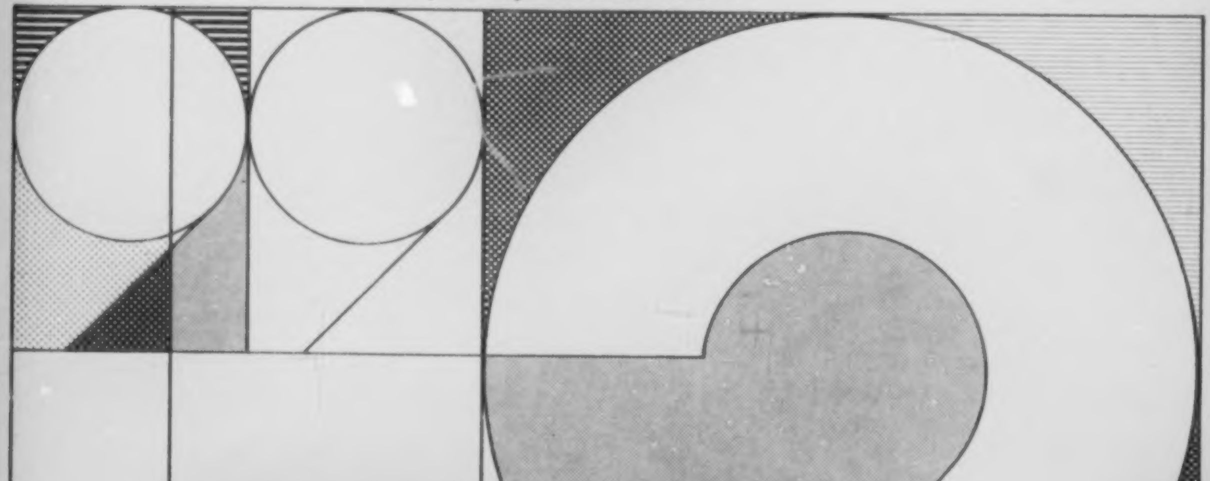
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

MARCH 1986

Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget — Part II

As Required by Public Law 93-344



J932-14

1986 ANNUAL REPORT

REDUCING THE DEFICIT:

SPENDING AND REVENUE OPTIONS

The Congress of the United States
Congressional Budget Office

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Dashes in tables in this report indicate amounts less than $2.5 million.

Details in the text and tables of this report may not add to totals because of rounding.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in two parts, with this report constituting Part II. Part I is entitled *The Economic and Budget Outlook: Fiscal Years 1987-1991*.

This report provides background information for each major spending area of the budget and for revenues, and analyzes various specific options that would reduce the deficit. The inclusion of an option in the report, or the omission of one, does not imply a recommendation by CBO. In accordance with CBO's mandate to provide objective and impartial analysis, this report contains no recommendations.

All divisions of the Congressional Budget Office contributed to this report, which was prepared under the supervision of Robert W. Hartman. Martin D. Levine was responsible for Section I. John D. Mayer, Stephen H. Long, James G. Vertrees, Elliot Schwartz, Earl A. Armbrust, and Eric Toder were responsible for coordinating the specific deficit reduction options in Section II of this volume. Budget authority and outlay estimates were coordinated by Charles E. Seagrave, Robert A. Sunshine, Michael A. Miller, and William P. Myers. Revenue and outlay projections were prepared under the supervision of Rosemary D. Marcuss and Paul N. Van de Water, respectively. The Joint Committee on Taxation provided estimates of revenue options.

Paul L. Houts supervised the editing and production of the report, assisted by Nancy H. Brooks. Major portions were edited by Patricia H. Johnston, Francis S. Pierce, Sherry Snyder, and Johanna Zacharias. Others who assisted in preparing the manuscript for publication were Mary Braxton, Jill Bury, Gwen Coleman, Antoinette Foxx, Paula Gatens, Shirley Hornbuckle, Betty Jarrells, Patricia Joy, Rebecca Kees, Norma Leake, Angela McCullough, Ronald Moore, and Kathryn Quattrone.

Rudolph G. Penner
Director

March 1986

CONTENTS

SECTION I REDUCING THE DEFICIT 1

CHAPTER I INTRODUCTION 3

The Outlook for the Federal Deficit 3
The Context of Budget Decisions for 1987 8

CHAPTER II ALTERNATIVE APPROACHES TO MEETING THE DEFICIT TARGETS 13

The Starting Point 13
Alternative Deficit Reduction Approaches 18

SECTION II SPENDING AND REVENUE OPTIONS 29

How to Use This Volume 31

National Defense 33
- DEF-01 Amend the Administration's Airlift Plan 34
- DEF-02 Reduce Construction of New Submarines and Extend the Service Life of Existing Ships 36
- DEF-03 Cancel or Reduce Procurement of the F-15 37
- DEF-04 Cancel the Army Helicopter Improvement Program 38
- DEF-05 Cancel Procurement of Aquila Remotely Piloted Vehicle 39
- DEF-06 Cancel V-22 Aircraft Development 41
- DEF-07 Cancel E-6 Aircraft Procurement 43
- DEF-08 Cancel M9ACE Armored Combat Earthmover 44

DEF-09 Cancel the Advanced Medium-Range, Air-to-Air Missile 46
DEF-10 Delay Advanced Tactical Fighter (ATF) Development 48
DEF-11 Delay Procurement of Trident II Missile 49
DEF-12 Cancel the Bradley Fighting Vehicle 50
DEF-13 Reduce MX Test Missiles 52
DEF-14 Alter Funding for Supporting Procurement 54
DEF-15 Alter Research and Development Funding 56
DEF-16 Slow Growth in the Strategic Defense Initiative 58
DEF-17 Alter Funding for Military Construction 59
DEF-18 Slow Increases in the Tactical Air Force 60
DEF-19 Place Three Carrier Battle Groups in Reserve 62
DEF-20 Retire Some G-Model B-52 Strategic Bombers Early 64
DEF-21 Alter Operation and Maintenance Funding 66
DEF-22 Restore Former Enlisted-Officer Ratios 68
DEF-23 Impose Fees for Military Outpatient Care 70
DEF-24 Selectively Raise Military Pay 71
DEF-25 Implement Proposed Changes in Military Retirement 73

Entitlements and Other Mandatory Spending 77
ENT-01 Tax Employer-Paid Health Insurance 78
ENT-02 Reduce Medicare's Payments for Indirect Medical Education Costs 81

ENT-03 Reduce Reimbursements for Capital Expenditures Under Medicare 83
ENT-04 Reduce Medicare's Payments to Hospitals for Direct Medical Education Expenses 87
ENT-05 Increase the Hospital Insurance Payroll Tax 89
ENT-06 Adopt a Fee Schedule for Reimbursing Physicians Under Medicare 90
ENT-07 Increase Medicare's Premium for Physicians' Services 93
ENT-08 Use the Tax System to Impose a Supplementary Income-Related Premium for Physicians' Services 95
ENT-09 Tax a Portion of Medicare Benefits 97
ENT-10 Increase Medicare's Deductible for Physician Services 99
ENT-11 Limit Payments for Long-Term Care Services 100
ENT-12 Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs 102
ENT-13 Limit the Increase in the Social Security "Bend Points" 106
ENT-14 Reduce the Replacement Rate Within Each Bracket of the Social Security Benefit Formula 108
ENT-15 Lengthen the Social Security Benefit Computation Period by Three Years 110

ENT-16 Eliminate Social Security Benefits for Children of Retirees Aged 62-64 111
ENT-17 Cover All Newly Hired State and Local Government Workers Under Social Security and Medicare 112
ENT-18 Eliminate Veterans' Compensation Payments for Those With Low-Rated Disabilities 114
ENT-19 Require a Two-Week Waiting Period for Unemployment Insurance Benefits 116
ENT-20 Index the Unemployment Insurance Taxable Wage Base 118
ENT-21 Reduce Guaranteed Student Loan Subsidies 120
ENT-22 Reduce the Subsidy for Nonpoor Children in Child Nutrition Programs 123
ENT-23 Reduce and Retarget Aid for Dependent Care 125
ENT-24 Terminate General Revenue Sharing 127

Agricultural Price Supports 129
AGR-01 Reduce Deficiency Payments by Lowering Target Prices 130
AGR-02 Eliminate Deficiency Payments on Excess Acreage 131
AGR-03 Reduce Deficiency Payments by Lowering Payment Limitation 132

NonDefense Discretionary Spending 133
NDD-01 Withdraw Most Federal Aid for Public Works Infrastructure 134

NDD-02 Reduce Support for Energy Supply, Conservation, and the Strategic Petroleum Reserve 138
NDD-03 Eliminate Federal Subsidies to Business 140
NDD-04 Scale Back Nondefense Construction Projects 142
NDD-05 Reduce Funding for Foreign Aid 145
NDD-06 Recover the Administrative Costs of Selected Regulatory Agencies 147
NDD-07 Charge State Member Banks and Bank Holding Companies for the Costs of Federal Reserve Supervision and Regulation 149
NDD-08 Raise Aviation User Fees to Cover Air Traffic Control Costs 152
NDD-09 Establish User Fees for Certain Coast Guard Services 154
NDD-10 Eliminate Cargo Preference for Nonmilitary Shipments 156
NDD-11 Reduce Support for Inland Waterways 158
NDD-12 Eliminate Federal Maintenance Assistance for Deep Draft Ports 160
NDD-13 Eliminate AMTRAK Subsidies 162
NDD-14 Reduce Federal Mass Transit Aid 164
NDD-15 Reduce and Refocus Highway Spending 166
NDD-16 Eliminate Federal Support to States for Construction of Sewage Treatment Plants 168

NDD-17 Reduce Credit Subsidies to Federal Power Marketing Administrations ... 170
NDD-18 End the Export-Import Bank Direct Loan Program ... 172
NDD-19 Discontinue Postal Subsidies for Not-for-Profit Organizations ... 174
NDD-20 End Funding for the Legal Services Corporation ... 176
NDD-21 Eliminate New Lending or Increase Homeowners' Payments Under Rural Housing Loan Program ... 177
NDD-22 Impose a One-Year Moratorium on New Funding for the Rural Rental Assistance Program ... 179
NDD-23 Reduce Subsidies for Low-Income Assisted Housing ... 180
NDD-24 Eliminate or Restrict Eligibility for Community Development Block Grants ... 183
NDD-25 End Funding of the Economic Development Administration and Urban Development Action Grants ... 185
NDD-26 Eliminate Funding for Untargeted Elementary and Secondary Education Programs ... 187
NDD-27 Increase Pell Grant Targeting ... 189
NDD-28 Reduce Campus-Based Student Aid ... 191

NDD-29 Reduce Funding for the Job Training Partnership Act 193

NDD-30 Modify the Davis-Bacon Act by Raising the Contract Threshold and Allowing Unrestricted Use of Helpers 195

NDD-31 Convert Underused Acute-Care Beds in VA Hospitals 197

NDD-32 Require Cost Sharing for VA Hospital Care 199

NDD-33 Limit Eligibility for VA Hospital Care to Service-Disabled and Poor Veterans 201

Personnel Costs 203

PERS-01 Cap Pay Adjustments for Federal Civilian Employees 204

PERS-02 Eliminate Cost-ofLiving Adjustments for Federal Retirees Under Age 62 207

PERS-03 Reduce Civil Service Retirement Benefits 209

PERS-04 Establish Supplemental Federal Retirement Benefits for New Workers 211

PERS-05 Require the Postal Service to Pay the Full Cost of Retirement and Other Benefits 213

PERS-06 Modify the Federal Employees Health Benefits Program 215

PERS-07 Reduce Federal Travel Expenses 217

Revenues 219
REV-01 Raise Marginal Tax Rates for Individuals 221
REV-02 Amend or Repeal Indexing of Income Tax Rates 223
REV-03 Impose a Corporate Surtax 226
REV-04 Impose a Value-Added or National Sales Tax 228
REV-05 Increase Energy Taxes 232
REV-06 Increase Excise Taxes 237
REV-07 Revise Depreciation Rules 241
REV-08 Match Income with Expense for Multiperiod Construction 246
REV-09 Eliminate Investment Tax Credit or Require Full Basis Adjustment 249
REV-10 Reduce Incentives for Building Rehabilitation 251
REV-11 Repeal Percentage Depletion Allowance and Expensing of Intangible Drilling, Exploration, and Development Costs 253
REV-12 Eliminate Private-Purpose Tax-Exempt Bonds 256
REV-13 Eliminate Special Capital Gains Treatment for Timber, and for Coal and Iron Ore Royalties 260
REV-14 Eliminate Preferences for Financial Institutions 262
REV-15 Restrict Use of the Cash Method of Accounting 266
REV-16 Repeal the Dividend Exclusion 268

REV-17 Repeal the Tax Credit for Employee Stock Ownership Plans 269
REV-18 Repeal 401(k) Plans or Lower the Maximum Contribution 270
REV-19 Decrease Maximum Limits on Pension Contributions and Pension Benefits 272
REV-20 Repeal Three-Year Basis Recovery Rule for Contributory Retirement Plans 273
REV-21 Tax a Portion of Non-Retirement Fringe Benefits 275
REV-22 Tax Cash Allowances and the Rental Value of Housing Provided to Persons in the Uniformed Services and the Clergy 279
REV-23 Restrict Deductions for Business Entertainment and Meals 281
REV-24 Eliminate State and Local Tax Deductibility 283
REV-25 Limit Interest Deductions 286
REV-26 Combine Miscellaneous Deductions and Employee Business Expense Deductions and Subject to a Floor of 1 Percent of AGI 288
REV-27 Increase Taxation of Non-Means-Tested Entitlement Benefits 290
REV-28 Eliminate Extra Tax Exemption for the Elderly and the Blind 294

REV-29 Disallow Income Averaging for Former Students 296
REV-30 Improve Tax Compliance and Enforcement 298
REV-31 Reduce Tax Preferences Across the Board 300
REV-32 Expand Minimum Taxes 302
REV-33 Repeal the Possessions Tax Credit 306
REV-34 Place a Per-Country Limit on the Foreign Tax Credit 307
REV-35 Tax Capital Gains at Death 308

APPENDIX SUMMARY TABLE OF SPENDING AND TAXATION OPTIONS BY BUDGET FUNCTION 311

TABLE I-1 BASELINE BUDGET PROJECTIONS AND UNDERLYING ECONOMIC ASSUMPTIONS ... 4

TABLE I-2 CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 7

TABLE II-1. CBO BASELINE OUTLAY PROJECTIONS FOR MAJOR SPENDING CATEGORIES 14

TABLE II-2. BASELINE REVENUE PROJECTIONS BY SOURCE 17

TABLE II-3. OUTLAYS AND REVENUES UNDER THE ADMINISTRATION'S 1987 BUDGETARY PROPOSALS AND AS REESTIMATED BY CBO 21

BOX I-1 ON-BUDGET AND OFF-BUDGET SPENDING AND REVENUES 5

BOX I-2 MAXIMUM DEFICIT AMOUNTS AND DEFICIT REDUCTION TIMETABLE UNDER THE BALANCED BUDGET ACT 10

BOX I-3 FALLBACK DEFICIT REDUCTION PROCEDURES UNDER THE BALANCED BUDGET ACT 11

BOX II-1 FEDERAL SPENDING CATEGORIES 15

BOX II-2 WHAT DOES FREEZING THE BUDGET MEAN? 23

FIGURE 1 BASELINE DEFICITS COMPARED TO TARGETS IN THE BALANCED BUDGET ACT 8

FIGURE 2 POLICY CHANGES AND RESULTING INTEREST SAVINGS REQUIRED TO MEET DEFICIT TARGETS UNDER THE BALANCED BUDGET ACT 25

SECTION I

REDUCING THE DEFICIT

CHAPTER I

INTRODUCTION

Actions taken during the first session of the 99th Congress to restrain federal spending have appreciably improved the outlook for the budget. But unless additional steps are taken either to lower spending or to raise revenues, annual deficits are projected to remain above $100 billion for the rest of the decade. Furthermore, the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177) mandates that the deficit be reduced to levels below those that would be achieved under current policies, until a balanced budget is reached by 1991.

This volume briefly describes the outlook for the deficit and offers numerous options for helping to meet the targets laid out in the Balanced Budget Act. The remainder of this chapter presents the Congressional Budget Office's (CBO's) baseline deficit projections and describes the unique context in which budgetary decisions will be made this year. Chapter II outlines several general approaches for meeting the statutory deficit limits. The remainder of the volume presents 127 specific options for raising revenues or reducing outlays that can be used to develop alternative deficit reduction plans.

THE OUTLOOK FOR THE FEDERAL DEFICIT

Under CBO's current baseline projections, the total federal deficit is estimated to decline from $208 billion in 1986 to $181 billion in 1987 and to $104 billion by 1991 (see Table I-1 and Box I-1 for projected deficits and budgetary concepts). These projections assume that the spending reduction order issued by the President on February 1, 1986, pursuant to the Balanced Budget Act, goes into effect.[1] That order would cancel--or"sequester"--

---

[1] As described later in this chapter, the constitutionality of the automatic deficit reduction procedure that gave rise to the President's order is under challenge in court. Even if the Supreme Court eventually finds the order to be invalid, however, the Congress could effectively enact it under fallback procedures contained in the Balanced Budget Act. (See Box I-3 for a description of the fallback procedures.)

TABLE I-1. BASELINE BUDGET PROJECTIONS AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1985	1986	1987	1988	1989	1990	1991
	Budget Projections (By fiscal year, in billions of dollars) a/						
Baseline Estimates							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
	Economic Assumptions (By calendar year)						
Nominal GNP, percent change	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP, percent change	2.3	3.2	3.1	3.3	3.5	3.5	3.2
CPI-W, percent change	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.8	6.7	6.4	6.1	5.7	5.4

SOURCE: Congressional Budget Office.

a. Includes both on-budget and off-budget outlays and revenues. See Box I-1 for elaboration.

budgetary resources sufficient to reduce 1986 outlays by more than $11 billion. For fiscal year 1987 and beyond, CBO's baseline projections assume that funding for most programs grows only at a rate sufficient to maintain the 1986 postsequestration level of services in real terms.

These baseline projections are in sharp contrast to those of only one-half year ago. According to CBO projections prepared in August 1985, policies then being pursued would have resulted in deficits of nearly $300 billion by 1990. The difference between the earlier projection and the current one

BOX I-1.
ON-BUDGET AND OFF-BUDGET SPENDING AND REVENUES

Total federal outlays and revenues include both on-budget and off-budget activities. The 1985 Balanced Budget Act returned to on-budget status all previously off-budget activities--primarily lending activities carried out through the Federal Financing Bank and the purchase of oil for the Strategic Petroleum Reserve. Simultaneously, however, the act moved off-budget two Social Security trust funds--Old-Age and Survivors Insurance and Disability Insurance (OASDI). Although these trust funds are separate for accounting purposes, their outlays and revenues affect the total federal debt that must be financed by borrowing from the public and are included in calculating the deficit amount for the purposes of the Balanced Budget Act.

Section I of this volume considers both on- and off-budget outlays and revenues in describing aggregate federal fiscal activities, because both are significant for the economy and for implementation of the Balanced Budget Act. Similarly, Section II contains options that would either reduce Social Security outlays or increase revenues paid into the OASDI funds, because both sorts of options could contribute to meeting the deficit targets in the Balanced Budget Act. (The act specifies that it shall not be in order to consider any provision affecting Social Security outlays or revenues as a part of a budget reconciliation bill, but the Congress could consider such changes as a part of other legislation.) Although changes in Social Security outlays or revenues could contribute to reducing the overall federal deficit, as the following table illustrates, the Social Security trust funds themselves are currently in surplus, and that surplus is expected to grow for many years.

Baseline Budget Projections
(In billions of dollars)

	1986	1987	1988	1989	1990	1991
Revenues						
On-budget	580	631	680	730	781	832
Off-budget (OASDI)	198	213	241	261	287	312
Total	778	844	921	991	1,068	1,144
Outlays						
On-budget	802	827	876	913	953	999
Off-budget (OASDI)	184	198	210	222	235	249
Total	986	1,025	1,086	1,135	1,188	1,248
Deficit (-) or Surplus						
On-budget	-222	-196	-195	-183	-172	-167
Off-budget (OASDI)	14	15	31	39	52	63
Total	-208	-181	-165	-144	-120	-104

is partly attributable to spending policies adopted by the Congress since then and partly attributable to changes in assumptions regarding the future (see Table I-2).

The largest changes in budget projections were in national defense. First, appropriations for 1986 fell well below the 5 percent real growth called for in the 1985 Congressional budget resolution, and the 1986 sequestration will reduce the amount of new budget authority still further. Assumptions for the out-years have changed as well. Whereas the August 1985 projections assumed continued real growth, CBO's current baseline projections assume zero real growth in defense appropriations from the 1986 postsequestration level. This change is made on the grounds that the deficit targets in the Balanced Budget Act, as an expression of Congressional policy, supersede the future defense spending levels specified in earlier budget resolutions. (In the absence of any defined future defense policy, the current CBO baseline projects the defense portion of the budget in the same manner as it projects nondefense discretionary programs, adjusting it for inflation only.) Together, these changes account for a reduction of $96 billion in projected defense spending in 1990, relative to the level CBO projected last August.

Appropriation acts and the 1986 sequestration also reduced projected spending for appropriated nondefense programs by a total of $22 billion in 1990, relative to the August 1985 estimate. Changes in entitlements and other spending programs--including savings through sequestration--accounted for an additional $12 billion of the difference in the 1990 deficit projections. More than $50 billion of the reduction in the projected 1990 deficit is accounted for by interest savings resulting from two factors--reduced borrowing needs because of the policy changes outlined above and lower interest rate assumptions than were used last August. Projected 1990 revenues declined by $16 billion between the August forecast and the present one, partially offsetting the deficit reductions listed above.

Under CBO's current baseline assumptions, future deficits would represent a declining share of the gross national product (GNP), and the growth of the federal debt would slow appreciably. Annual deficits are projected to decline from 5.0 percent of GNP in 1986 to 1.7 percent of GNP by 1991. If this deficit path were followed, publicly held federal debt would rise from $1.7 trillion to $2.4 trillion. In relation to GNP, debt held by the public would increase from 41.0 percent in 1986 to a peak of 42.7 percent in 1988 and then decline to 40.2 percent by the end of 1991. 2/

---

2. For more detail on the budget outlook, see CBO's *The Economic and Budget Outlook: Fiscal Years 1987-1991* (February 1986).

TABLE I-2. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212	229	243	264	285
MAJOR CHANGES					
Lower Defense Outlays					
1986 appropriations	-4	-14	-28	-42	-56
1986 sequestration	-6	-9	-11	-11	-12
Assumed zero real growth after 1986 sequestration	--	-3	-10	-18	-28
Subtotal	-9	-26	-48	-71	-96
Lower Nondefense Discretionary Spending					
1986 appropriations	-7	-14	-14	-15	-15
1986 sequestration	-4	-5	-6	-6	-7
Subtotal	-10	-19	-20	-21	-22
Changes in Other Noninterest Outlays	6	-4	-4	-8	-12
Lower Net Interests Costs					
Reduced borrowing needs as a result of policy changes	4	a/	-5	-13	-20
Lower interest rate assumptions	-3	-8	-11	-18	-31
Subtotal	a/	-7	-16	-31	-51
Lower Revenues	9	9	10	11	16
Total Changes	-4	-48	-78	-120	-165
February 1986 Baseline Deficit	208	181	165	144	120

SOURCE: Congressional Budget Office.

NOTE: Includes both on-budget and off-budget outlays and revenues.

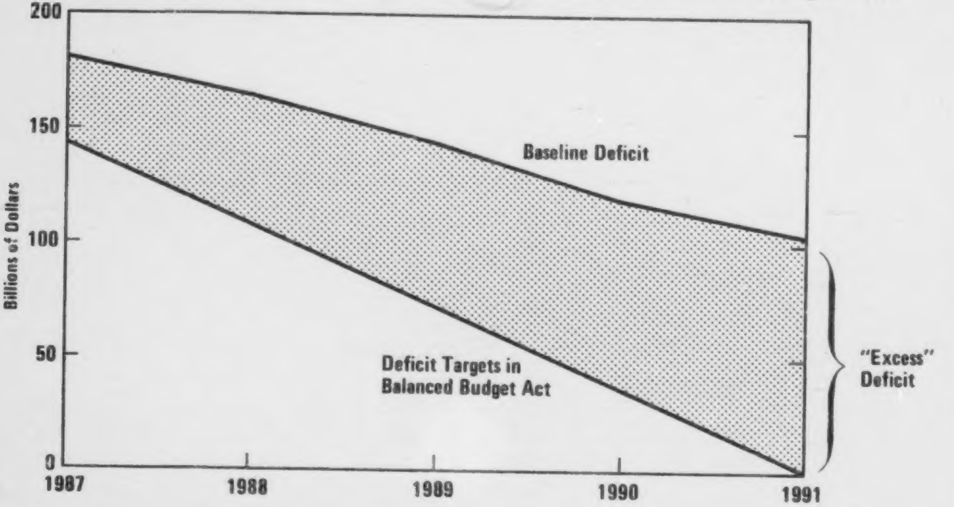
a. Less than $500 million.

THE CONTEXT OF BUDGET DECISIONS FOR 1987

Although the deficit picture has improved markedly in the past half year, projected budget imbalances remain large by historical standards. They also exceed the deficit targets specified in the Balanced Budget Act--by $37 billion in 1987, and by more than $350 billion over the 1987-1991 period (see Figure 1).

In an important sense, the Balanced Budget Act sets the terms for budget deliberations for the remainder of the decade. The act specifies maximum deficit amounts for fiscal years 1986 through 1991, leading to a balanced budget in that year. It also requires that, beginning in fiscal year 1987, the Administration's budget submissions and the Congressional budget resolutions lead to deficits equal to or less than the legislated maximums. Finally, the Balanced Budget Act specifies that if legislation that would achieve the deficit target for the year (or within $10 billion of the target for fiscal years 1987 through 1990) has not been enacted by the beginning of each fiscal year, across-the-board spending cuts are to be made in amounts

Figure 1.
Baseline Deficits Compared to Targets in the Balanced Budget Act[a]



SOURCE: Congressional Budget Office.

[a] Includes both on-budget and off-budget outlays and revenues.

that would eliminate the entire "excess" deficit. (See Box I-2 for the deficit targets and timetable under the Balanced Budget Act.) 3/

On February 1, 1986, the President issued the first sequestration order under the Balanced Budget Act. The order, which has an effective date of March 1, would cancel more than $30 billion in budgetary resources--principally budget authority, direct loan authority, and loan guarantee authority--thereby reducing federal outlays by about $11.7 billion in 1986, with additional savings in future years. 4/ The automatic deficit reduction procedures were challenged in court, however, and on February 7, 1986, a three-judge district court panel found one aspect of those procedures to be in violation of the Constitution and declared the President's order to be "without legal force and effect." 5/ In accordance with another provision of the Balanced Budget Act, the district court stayed the effect of its own decree pending appeals to the Supreme Court. Thus, the sequestered budgetary resources remain unavailable, despite the panel's decision.

If the decision of the lower court is reversed, the sequestered budgetary resources would be canceled. On the other hand, if the Supreme Court affirms the lower court's judgment, those resources probably would become available for use, although the Court might fashion a remedy that would not void the 1986 order completely. In any event, if the Supreme Court does void the February 1 order, a fallback procedure laid out in the Balanced Budget Act could then be used to reinstate the reductions. Under that procedure, the Congress could, in effect, enact the sequestration order through a joint resolution that would become law if passed by majority vote of both Houses and signed by the President. 6/ (See Box I-3 for a description of the fallback procedure).

---

3. The Balanced Budget Act also reinforces procedural barriers against consideration of individual pieces of legislation that would have the effect of breaching the deficit targets.

4. Section 256(a)(2) of the Balanced Budget Act provides an exception in the case of amounts sequestered in special or trust funds. In these cases, the sequestered resources remain in the funds, but the Balanced Budget Act limits expenditures.

5. Under the Balanced Budget Act, the Presidential order to sequester resources is triggered by a report to the President from the Comptroller General, who heads the General Accounting Office. The court found that because the Comptroller General can be removed by the Congress, it is constitutionally improper for him to exercise such an executive role.

6. The cuts could also be made through a series of rescission proposals by the President, if they were approved by the Congress.

BOX I-2.
MAXIMUM DEFICIT AMOUNTS AND DEFICIT REDUCTION TIMETABLE UNDER THE BALANCED BUDGET ACT

Maximum Deficit Amounts

Year	Maximum Deficit (In billions of dollars)
1986	171.9
1987	144.0
1988	108.0
1989	72.0
1990	36.0
1991	0.0

NOTE: Sequestration in 1986 is limited to $11.7 billion. In fiscal years 1987 through 1990, sequestration would be triggered only if the estimated deficit exceeds the maximum by more than $10 billion.

TIMETABLE FOR FISCAL YEAR 1986

January 10	Policy "snapshot" of the deficit for fiscal year 1986 is taken. Laws and regulations as of this date are used for the January 15 report.
January 15	Directors of the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) report to the Comptroller General on the deficit outlook and needed spending cuts.
January 21	Comptroller General issues report to the President, based on the OMB/CBO findings.
February 1	Presidential sequestration order is issued based on the Comptroller General's report.
March 1	Sequestration order takes effect.

TIMETABLE FOR FISCAL YEAR 1987 AND THEREAFTER

August 15	Policy "snapshot" of the deficit is taken. Laws and regulations as of this date are used for August 20 report.
August 20	Directors of OMB and CBO report to the Comptroller General on deficit outlook and needed spending cuts.
August 25	Comptroller General issues report to the President.
September 1	If a sequestration is called for, the initial Presidential order is issued based on the Comptroller General's report.
October 1	Initial order takes effect; sequestered funds are withheld from obligation.
October 5	Directors of OMB and CBO issue revised report to reflect final Congressional action on efforts to reduce the deficit.
October 10	Comptroller General issues revised report to the President.
October 15	If a sequestration is still necessary, the final Presidential order, based on the revised report, is effective; sequestered funds are permanently canceled.

As noted, *CBO's baseline budget projections assume* that the reductions in 1986 funding called for under the February 1 order will eventually go into effect--either as a result of a ruling by the Supreme Court upholding the constitutionality of the automatic deficit reduction mechanism, or by subsequent legislation. By reducing the amount of budgetary resources available in 1986, those cuts--if they do go forward--will reduce outlays for many years into the future, thereby also contributing toward meeting the statutory targets for 1987 and beyond. Thus, if the Court strikes down the sequestration order, and if it is not enacted through legislation, the spending cuts or revenue increases necessary to meet the targets for 1987 through 1991 will have to be that much larger.

BOX I-3.
FALLBACK DEFICIT REDUCTION PROCEDURES UNDER THE BALANCED BUDGET ACT

Section 274(f) of the Balanced Budget and Emergency Deficit Control Act of 1985 provides for a fallback deficit reduction mechanism if any of the reporting procedures that trigger automatic spending cuts are found to be unconstitutional.

Under the fallback procedure, the Comptroller General's involvement in the process would be eliminated. Instead, on those dates on which the Directors of the Office of Management and Budget and the Congressional Budget Office would have reported to the Comptroller General, they would report to a Temporary Joint Committee on Deficit Reduction comprising the full membership of the Senate and House Committees on the Budget. The Joint Committee would be required to report within five days a joint resolution "setting forth the contents of the report of the Directors." Presumably this resolution would have the effect of enacting through legislation the across-the-board spending reductions that would otherwise have occurred through Presidential order. Each House would then have five days after the resolution was reported to vote on it, with special rules applying that would expedite its consideration and prohibit amendments to it. As with any other joint resolution, in order to become law it would have to be passed by each House of the Congress and signed by the President, or passed by a two-thirds vote of each House in the event of a Presidential veto.

In ruling the automatic deficit reduction procedures to be unconstitutional on February 7, 1986, a district court panel found that the fallback mechanism was consistent with the Constitution.

However the uncertainty regarding the 1986 sequestration is resolved, if by next fall the deficit for 1987 is estimated to exceed the statutory maximum of $144 billion by more than $10 billion, the Congress and the President will be faced with the prospect of another across-the-board spending reduction--either through executive order or through a joint resolution that would legislate the spending reductions. It is the prospect of further across-the-board cuts that drives the need to act and that distinguishes this budget cycle from any previous one.

CHAPTER II

ALTERNATIVE APPROACHES TO MEETING THE DEFICIT TARGETS

Numerous approaches are available to the Congress for achieving the statutory deficit targets for 1987 and beyond. The choice among competing approaches involves basic judgments about the appropriate scope and role of the federal government. In short, what services should be provided, and how should those services be financed?

THE STARTING POINT

Any discussion of how to accommodate federal spending and taxing policies to the constraints of the Balanced Budget Act logically begins with a consideration of outlays and revenues under current policies. Although the automatic deficit reduction procedures in the Balanced Budget Act would close the remaining deficit gap solely by reducing outlays, the options available to the Congress encompass both spending and revenues.

The Composition of Outlays

On the outlay side of the ledger, a large share of federal activity is concentrated in a limited number of areas (see Table II-1). Of total 1987 baseline outlays, more than one-fourth will be devoted to national defense, and more than two-fifths will be devoted to entitlements and other mandatory spending programs, the largest of which are retirement and health care programs for the elderly that do not require recipients to meet any test of need. All the remaining functions of government together (other than interest payments) account for less than one-fifth of total spending. Outlays for these purposes are referred to in this volume as nondefense discretionary spending. (See Box II-1 for definitions of spending categories.)

Relative to the economy as a whole, total federal spending under CBO's baseline assumptions would amount to 22.8 percent of GNP in 1987--down seven-tenths of a percentage point from 1986, and the lowest

TABLE II-1. CBO BASELINE OUTLAY PROJECTIONS FOR MAJOR SPENDING CATEGORIES (By fiscal year)

Major Category	1985 Actual	1986 Base	Projections 1987	1988	1989	1990	1991
			In Billions of Dollars				
National Defense	253	269	284	296	311	327	344
Entitlements and Other Mandatory Spending	440	454	474	509	536	567	604
Nondefense Discretionary Spending	172	173	174	183	188	196	204
Net Interest	129	139	145	154	158	159	160
Offsetting Receipts	-48	-49	-51	-56	-58	-61	-64
Total	946	986	1,025	1,086	1,135	1,188	1,248
On-Budget	769	802	827	876	913	953	999
Off-Budget (OASDI) a/	177	184	198	210	222	235	249
			As a Percent of GNP				
National Defense	6.4	6.4	6.3	6.1	6.0	5.8	5.7
Entitlements and Other Mandatory Spending	11.2	10.8	10.5	10.5	10.3	10.1	10.0
Nondefense Discretionary Spending	4.4	4.1	3.9	3.8	3.6	3.5	3.4
Net Interest	3.3	3.3	3.2	3.2	3.0	2.8	2.7
Offsetting Receipts	-1.2	-1.2	-1.1	-1.2	-1.1	-1.1	-1.1
Total	24.0	23.5	22.8	22.4	21.8	21.1	20.6
On-Budget	19.5	19.1	18.4	18.1	17.5	17.0	16.5
Off-Budget (OASDI) a/	4.5	4.4	4.4	4.3	4.3	4.2	4.1

SOURCE: Congressional Budget Office.

a. Refers to outlays for Old-Age, Survivors, and Disability Insurance (Social Security). See Box I-1 for a description of the budgetary treatment of Social Security.

BOX II-1.
FEDERAL SPENDING CATEGORIES

National Defense. Outlays for military and civilian personnel, operating costs, weapons procurement, research and development, and military construction.

Entitlements and Other Mandatory Spending. Programs in which spending is governed by a law making all who meet their requirements eligible to receive payments. Subcategories are:

> **Health Care**. Includes outlays for Medicare and for the federal share of Medicaid expenditures.
>
> **Social Security and Other Retirement and Disability Programs**. Includes old-age, survivors, and disability benefits under Social Security, as well as other federally financed retirement and disability programs, including federal civil service and military retirement and disability programs, veterans' pensions and compensation, and Supplemental Security Income. (As described in Box I-1, Social Security expenditures are now classified as off-budget.)
>
> **Other Entitlements and Mandatory Spending**. Entitlements and other mandatory spending not included above. Major examples are: non-means-tested or partially means-tested benefits such as Unemployment Insurance, Guaranteed Student Loans, and child nutrition; means-tested benefits such as Food Stamps and Aid to Families with Dependent Children; certain state and local grants such as General Revenue Sharing and the Social Services Block Grant; and agricultural price supports.

Nondefense Discretionary Spending. All nondefense programs for which spending is determined by annual appropriations, or by loan or obligation limits imposed in appropriation acts. The basic governmental legislative, judicial, and tax-collecting functions are included. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of government. Most grants to state and local governments (other than for benefit payments) and nondefense research and development are also in this category.

Net Interest. Interest payments on the federal debt, less interest received by trust funds and other interest payments to the federal government.

Offsetting Receipts. Proprietary receipts from the public and the employer share of employee retirement. Other receipts (for example, foreign military sales, trust fund receipts, and payments to trust funds) appropriately netted against outlays are included in the relevant categories above.

share since 1981. Baseline spending for defense in 1987 would represent 6.3 percent of GNP, entitlements would account for 10.5 percent of GNP, and nondefense discretionary spending an additional 3.9 percent. By 1991 under CBO's baseline assumptions, total outlays would drop by another two percentage points to less than 21 percent of GNP, with the decline spread among all spending categories.

The Composition of Revenues

In contrast to outlays, total federal revenues are projected to remain nearly unchanged as a share of GNP during the projection period, hovering between 18.7 percent and 19.0 percent of the gross national product (see Table II-2). The composition of revenues would, however, change somewhat, with the share paid directly by individuals rising.

Between 1987 and 1991, individual income tax collections--the largest single source of revenues--would grow from 8.5 percent of GNP to 9.0 percent, and social insurance taxes and contributions (primarily Social Security revenues) would increase from 6.7 percent to 6.9 percent of GNP. During the same period, corporate income tax collections would rise very slightly then move downward to 1.9 percent of GNP by 1991. All remaining revenue sources taken together--excise taxes, customs duties, Federal Reserve payments, estate and gift taxes, and certain miscellaneous charges and fees--are projected to decline from 1.6 percent to 1.2 percent of GNP between 1987 and 1991.

Putting Outlays and Revenues Together

Although outlays and revenues are projected to converge under CBO's baseline projections, a gap equal to about 1½ percent of GNP would remain in 1991--the year in which the Balanced Budget Act requires that the deficit be zero. A deficit of this size cannot easily be eliminated by targeting any single sector of the budget. For example, focusing exclusively on defense would require a cutback of about one-fourth in that area; limiting cuts to entitlements would entail a reduction of about one-seventh below baseline levels; and relying solely on cuts in nondefense discretionary spending would require a reduction of more than one-third. Eliminating the deficit gap solely through increased revenues is also difficult. The amount needed would be roughly equivalent to a 15 percent surcharge on individual income

TABLE II-2. BASELINE REVENUE PROJECTIONS BY SOURCE (By fiscal year)

	1985	1986	Projections				
Major Category	Actual	Base	1987	1988	1989	1990	1991
			In Billions of Dollars				
Individual Income	335	354	385	422	461	501	543
Corporate Income	61	72	89	100	108	112	114
Social Insurance	265	281	301	332	355	385	415
Windfall Profit	6	4	2	2	2	2	1
Other Excises	30	29	29	28	27	28	29
Estate and Gift	6	6	6	5	5	5	6
Customs Duties	12	12	14	15	16	17	18
Miscellaneous	19	19	19	18	18	18	18
Total	734	778	844	921	991	1,068	1,144
On-Budget	548	580	631	680	730	781	832
Off-Budget (OASDI) a/	186	198	213	241	261	287	312
			As a Percent of GNP				
Individual Income	8.5	8.5	8.5	8.7	8.8	8.9	9.0
Corporate Income	1.6	1.7	2.0	2.1	2.1	2.0	1.9
Social Insurance	6.7	6.7	6.7	6.9	6.8	6.9	6.9
Windfall Profit	0.2	0.1	b/	b/	b/	b/	b/
Other Excises	0.8	0.7	0.6	0.6	0.5	0.5	0.5
Estate and Gift	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.5	0.4	0.4	0.4	0.3	0.3	0.3
Total	18.6	18.6	18.7	19.0	19.0	19.0	18.9
On-Budget	13.9	13.8	14.0	14.1	14.0	13.9	13.8
Off-Budget (OASDI) a/	4.7	4.7	4.7	5.0	5.0	5.1	5.2

SOURCE: Congressional Budget Office.

a. Refers to federal revenues paid into the Old-Age, Survivors, and Disability Insurance trust funds to finance Social Security benefits. See Box I-1 for a description of the budgetary treatment of Social Security.

b. Less than 0.05 percent.

taxes, or an increase of more than 70 percent in corporate tax revenues. [1] As a result, most budget plans attempt to gain ground on several fronts.

ALTERNATIVE DEFICIT REDUCTION APPROACHES

The Congress could adopt any mix of spending reductions and revenue increases to close the gap between CBO's baseline projections and the maximum deficits called for in the Balanced Budget Act. Alternatively, the Congress could choose what might be considered the "default" option of allowing a series of sequestrations to take place under provisions of the Balanced Budget Act.

Choosing among alternatives entails making judgments about what the scope and role of government ought to be. The Administration's budget proposal, for example, reflects a number of such judgments--that the level of resources devoted to defense should increase; that states and localities should assume a greater responsibility for certain functions now financed in part by the federal government; and that the provision of some other services should be left to the private sector. Even the option of relying on spending reductions under the Balanced Budget Act represents a set of judgments couched in rules governing what programs shall be cut and by how much.

The following describes the "default" option, the Administration's 1987 budget submission, and examples of alternative approaches.

Sequestration Under the Balanced Budget Act

If the Congress fails to act before the beginning of the next fiscal year to reduce deficits from projected baseline levels, it will be faced with the prospect of triggering a second sequestration to achieve the 1987 deficit target. Under guidelines specified in the Balanced Budget Act, several spending categories would be exempt from cuts. These include interest payments on the federal debt, Social Security benefits, state unemployment benefits, and several low-income assistance programs. Together these categories account for nearly 40 percent of all federal outlays. Another 14 percent of all outlays would be partially protected. These include indexed federal retirement and disability programs, for which the reduction would be limited to forgoing the annual cost-of-living adjustment; and Medicare, and several smaller health care programs, each of which would be subject to no more than a 2 percent cut. The remainder of the budget--new budgetary resources for defense and nondefense discretionary programs--would be subject to across-the-board cuts sufficient to eliminate the excess deficit. Overall, one-half the savings would come from cutbacks in defense, and one-half from reductions in nondefense programs.

---

[1] The size of needed deficit reductions relative to current policies include only savings required through program cutbacks or revenue increases. Some of the deficit gap would be closed by interest savings that would arise automatically because of lower federal borrowing needs resulting from the policy-related savings. (See discussion later in this chapter.)

The size of any across-the-board reduction for fiscal year 1987 is impossible to forecast at this time for two reasons. First, it will depend on the economic outlook as it will appear next fall. Second, the base for the cuts will not be known until then. The Balanced Budget Act specifies that the reductions in appropriated programs are to be taken from funding levels included in full-year appropriations, if they have been enacted by the time a sequestration is triggered. If a full-year appropriation (or a full-year continuing resolution) has not been enacted for a program, the size of the cut for that program is to be calculated from the funding level of the previous year.

While the size of any 1987 sequestration cannot be known now, illustrative calculations can be made. 2/ For example, if CBO's current economic forecast remains unchanged, if no changes in tax policies or in entitlements are adopted between now and next October, and if no full-year appropriations are enacted by then, across-the-board reductions of 6.2 percent in budgetary resources devoted to defense and 8.4 percent in nonexempt domestic programs would be required to achieve the 1987 deficit targets. These cuts would be taken from funding levels that would have already been reduced by between 4 percent and 5 percent from their 1986 appropriations, as a result of that year's sequestration. The cumulative effect would therefore be to reduce budgetary resources devoted to defense by 10.8 percent between the 1986 appropriation level and 1987, and to cut resources provided for nondefense discretionary programs by 12.3 percent over the same period. The reduction in real terms would be even greater

---

2. For a description of how the spending reductions would be calculated, see Chapter III of CBO's *The Economic and Budget Outlook: Fiscal Years 1987-1991* (February 1986).

because of the erosion in the buying power of the funds. Moreover, even after a second sequestration, further across-the-board cuts may be required to satisfy the deficit targets for 1988 and beyond.

As this example illustrates, while relying on sequestration might reduce budgetary resources in total increments that appear small in any particular year, the effect of the cutbacks could be substantial. If the Congress were to rely solely on sequestration to achieve all future deficit targets, then by 1991 total federal outlays would equal just under 19 percent of GNP, the lowest share since 1966. Also, the composition of outlays would change, with entitlements growing as a share of total spending, and outlays for appropriated defense and nondefense programs making up smaller shares of the total.

The Administration's Proposal

In its 1987 budget submission, the Administration has proposed a quite different path toward realizing the statutory deficit targets. 3/ Like sequestration, the Administration proposals would rely almost entirely on spending cuts. Unlike sequestration, however, the Administration would concentrate all reductions on nondefense spending. In fact, resources devoted to defense would grow by 6 percent in real terms between the 1986 postsequestration level and 1987, and by an average of about 3 percent per year in real terms between 1986 and 1991.

On the domestic side of the budget, cutbacks would be concentrated on discretionary programs, but would include substantial constraints on growth in some entitlements. Proposed cuts in appropriated programs include sizable reductions in housing, transportation, community and economic development, education, and environmental assistance. Savings in entitlement programs would be achieved primarily by eliminating General Revenue Sharing and by limiting growth in Medicare, Medicaid, and federal employee retirement and health care programs. The Administration is also proposing to raise receipts to the government through increased premiums charged for participants in the Supplementary Medical Insurance component of Medicare; fees charged for such services as navigation assistance, and customs and meat inspections; and the sale of five power marketing administrations and the Naval Petroleum Reserves.

---

3. For more detail on the Administration's plan, see CBO's *An Analysis of the President's Budgetary Proposals for Fiscal Year 1987* (February 1986).

The Administration estimates that its proposed policies would satisfy the Balanced Budget Act deficit targets. But under CBO's economic and technical assumptions, the Administration's plan would result in deficits that exceed the targets by about $16 billion in 1987 and by $40 billion in 1991 (see Table II-3). As reestimated by CBO, outlays in 1991 under the Administration's proposals would amount to 19.7 percent of GNP, and a deficit equivalent to 0.7 percent of GNP would remain.

TABLE II-3. OUTLAYS AND REVENUES UNDER THE ADMINISTRATION'S 1987 BUDGETARY PROPOSALS AND AS REESTIMATED BY CBO
(By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
Administration's Budgetary Proposals					
As estimated by the Administration					
Outlays	994	1,027	1,064	1,094	1,123
Revenues	850	933	996	1,058	1,124
Deficit (-) or Surplus	-144	-94	-68	-36	1
As reestimated by CBO					
Outlays	1,010	1,060	1,091	1,141	1,190
Revenues	850	928	1,000	1,075	1,150
Deficit (-) or Surplus	-160	-132	-91	-67	-40
Maximum Deficit (-) Under the Balanced Budget Act	-144	-108	-72	-36	0

SOURCE: Congressional Budget Office; Office of Management and Budget.

NOTE: Includes on-budget and off-budget outlays and revenues.

While the Administration's budget as reestimated by CBO would fall short of the Balanced Budget Act targets, it would greatly alter federal priorities. For example, annual outlays for national defense would rise by $33 billion by 1991, or about one-half percent of GNP, relative to CBO's baseline projections. Outlays for entitlements and other mandatory spending programs would fall by an amount roughly equal to the increase in defense. Spending for nondefense discretionary programs would be cut by $40 billion by 1991, or one-fifth below CBO's baseline projection.

Other Approaches

A virtually limitless number of options are available to the Congress in fashioning an alternative to either sequestration or the Administration's proposal. The Congress could alter the mix of spending cuts, place part of the burden on revenues, or do both.

Whatever the mix of spending and taxing changes, the Congress can construct deficit reduction plans either on the basis of general rules of thumb regarding the treatment to be afforded to different classes of programs, or by making program-by-program assessments. The sequestration procedure laid out in the Balanced Budget Act is, of course, an example of a set of general rules very broadly applied. The attraction of such an approach is that it greatly simplifies the enormous complexity of dealing individually with the more than 1,000 spending accounts. The risk is that some activities might be given unintendedly harsh or lenient treatment as a result of being included in some general category of federal activities.

Although the alternative of making all decisions on a program-by-program basis allows separate assessments of the relative value of different activities, it requires many more individual judgments and may be more difficult to coordinate legislatively. Most budget plans, therefore, involve some combination of the two approaches. They make specific judgments about some of the largest or most highly valued programs, while applying rules of thumb to others--for example, freezing appropriations for certain programs at their base-year levels, allowing others to grow only enough to keep up with inflation, and permitting still other programs to increase at some specified rate in excess of inflation. (See Box II-2 for a discussion of issues in defining a budget "freeze"--one commonly proposed formula approach to deficit reduction.)

BOX II-2.
WHAT DOES FREEZING THE BUDGET MEAN?

The term "budget freeze" has no single definition. It can, for example, mean holding spending constant in dollar terms; in this usage, government would decline in size, because this year's dollar cannot purchase as much as last year's. It can also mean holding spending constant in real terms by adding enough to offset the effects of inflation, in which case nominal spending would be higher after the freeze than before it.

However one defines budget freeze, there must always be exceptions--interest on the debt being the most obvious one. Contract commitments must be honored as well.

Entitlement programs in general are difficult to freeze. For example, unless eligibility rules are changed, Social Security spending will rise automatically as more people reach retirement age and as life expectancy increases. Medicare and federal civilian and military retirement programs present the same barrier to a freeze as does Social Security. Consequently, a budget freeze for such entitlements usually can only mean a limit on annual cost-of-living adjustments (COLAs) in those programs. Such a limit can take many forms, such as skipping the COLA for one or more years, or delaying the adjustment date by six months, or allowing only a partial adjustment.

For discretionary programs, freezes are generally applied to budget authority rather than to outlays, because that is what the Congress determines in the annual appropriation bills. The provision of new budget authority allows agencies to enter into spending obligations. But these obligations may not result in cash outlays until some years later. All of the administrative control mechanisms are designed to ensure that agency obligations do not exceed the amount of new budget authority provided each year. There are no administrative mechanisms in place to control the timing or amount of outlays.

A second general consideration is the timing of deficit reductions--that is, what the final deficit target should be and what intermediate goals should be sought. In passing the Balanced Budget Act, the Congress has legislated both the final objective and the year-by-year targets, but in so doing, it has placed serious constraints on any deficit reduction plan. Many policy changes designed to reduce federal spending over the long term generate savings only after several years have passed--for example, a phased-in modification to a federal employee retirement program, or a slowdown in the procurement of weapons for the military. Similarly, new taxes or sharp changes in the tax code often involve implementation lags or transition rules intended to avoid disrupting the economic plans of taxpayers. Relying solely on these kinds of changes--though quite appropriate for curbing a chronic deficit excess--might still result in high deficits in the short term.

Any proposal designed to satisfy fully each year's deficit target may therefore need to complement longer-term policy revisions with changes that would generate more rapid savings. Examples include eliminating or reducing cost-of-living adjustments for retirees, curtailing federal pay raises, or rescinding 1986 funds for slow-spending programs to generate savings in the early part of the 1987-1991 projection period. While some such options might also yield savings in later years, others might either increase costs in the out-years or lead to results unintended by their proponents. For example, focusing on achieving savings in 1987 defense outlays might invite such expedients as across-the-board cuts in operations and maintenance expenditures (buying fuel, performing maintenance, and the like), which could lower the readiness of the military to meet its current missions. Moreover, as this example suggests, some of these short-term stopgaps can have seriously adverse effects if repeated over an extended period, and thus are not substitutes for longer-term policy changes.

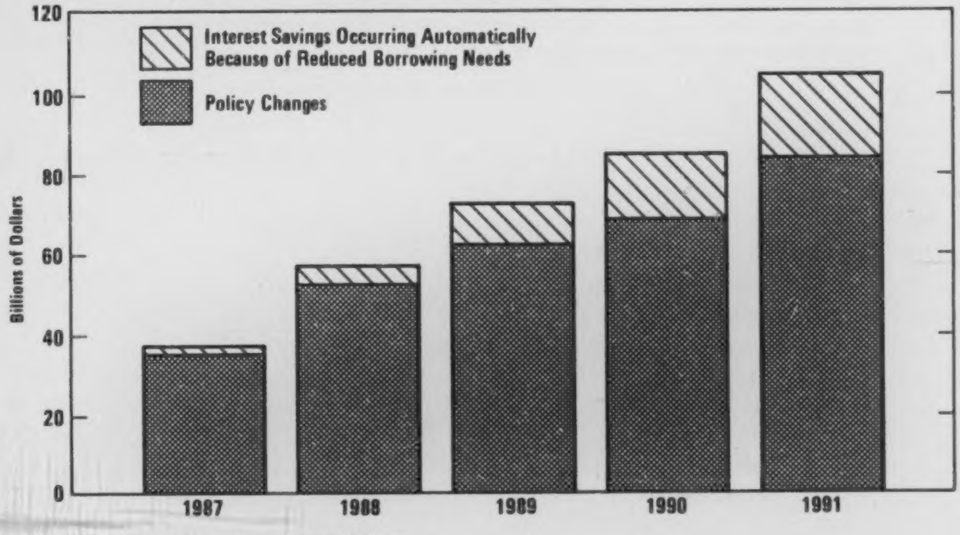
One final characteristic of the federal budget lessens the difficulty of achieving any set of deficit targets. Deficit reductions realized through program cutbacks or revenue increases yield additional automatic savings in the form of lower interest payments resulting from reduced federal borrowing needs. Because of these indirect savings, the policy changes required to satisfy the deficit targets specified in the Balanced Budget Act will be smaller than the total projected excess deficit. As shown in Figure 2, policy changes yielding direct savings of just under $36 billion in 1987 (relative to the CBO baseline deficit projection) would yield additional savings of about $1.5 billion through reduced borrowing needs. Together, these amounts would be sufficient to close the $37 billion gap between the baseline deficit projection and the statutory target. By 1991, policy changes yielding $83 billion in direct savings would be sufficient to eliminate the projected deficit of $104 billion; the additional $21 billion would be accounted for by interest savings generated in that year as a result of the policy changes required to meet the earlier deficit targets.

The examples of alternative deficit reduction approaches outlined below involve different combinations of spending reductions and revenue increases. Although the alternatives presented here focus on cutting spending or raising revenues relative to CBO's baseline projections, the Congress could choose to increase spending for some purposes relative to the baseline. (As noted, CBO's baseline is tightly defined, allowing for no real growth in discretionary programs.) Because of the constraints of the Balanced Budget Act, however, if the Congress chooses to devote additional resources to some areas, it would then have to either reduce other spending more sharply or raise revenues by a greater amount than would otherwise be necessary.

Full Reliance on Spending Cuts but Allocated Differently than Either Sequestration or the Administration's Proposal. One general alternative to either sequestration or the Administration's proposal would be to rely entirely on outlay reductions, but allocate the cuts differently among spending categories. Under this approach, the Congress would be accepting the judgment implicit in both sequestration and the Administration's proposal that

Figure 2.

Policy Changes and Resulting Interest Savings Required to Meet Deficit Targets Under the Balanced Budget Act



SOURCE: Congressional Budget Office.

revenue collections under current law define the appropriate bounds of government spending. The Congress would be making different choices, however, regarding how available funds should be spent.

One variant would be for the Congress to leave untouched those entitlements that both sequestration and the Administration would exempt from cuts (the largest of which, by far, is Social Security), while adopting a different mix of changes in other spending. For example, the Congress could accept the Administration's proposals for substantial real increases in defense spending, but in conjunction with a different set of domestic spending cuts. Alternatively, the Administration's defense plan could be trimmed, thereby reducing the size of the cuts that would have to be made in those domestic programs not placed off limits.

A different way to vary the mix of outlay changes would be to include reduction in some or all of the entitlements that would be exempt under both sequestration and the Administration's proposals. The size of any reduction in these entitlements would determine the net savings that would have to be achieved through changes in the remainder of all federal spending. For example, eliminating for one year the cost-of-living adjustments for all non-means-tested federal transfer programs, including Social Security, would generate annual savings of about $6 billion in 1987, rising to $8 billion four years later. This option would reduce by about 10 percent the cutbacks that would otherwise have to be made in other programs in order to balance the budget by 1991. If, instead, COLAs were limited to two percentage points less than the inflation rate for each of the next five years, annual savings would amount to $26 billion by 1991--reducing the burden borne by the rest of federal spending to about two-thirds of what would otherwise be required (see ENT-12 in Section II). 4/ By focusing exclusively on spending cuts, however, substantial real dollar decreases in other areas would still be necessary to satisfy the statutory deficit targets.

It is also worth noting that some revenue options could serve as very close substitutes for particular spending cuts. For example, increasing the taxation of Social Security benefits would reduce their net value and thus might arguably serve as an alternative to limiting COLAs (see REV-27). The two approaches would, however, have quite different effects on the distribution of after-tax income. Focusing only on outlay reductions might lead one to overlook analogous revenue options.

---

4. As noted in Box I-1, the Balanced Budget Act specifies that it shall not be in order to consider as part of a reconciliation bill any provision affecting Social Security.

Full Reliance on Revenue Increases. At the other extreme, the Congress could rely entirely on revenue increases to meet the statutory deficit targets. Under this approach, resources devoted to all major categories of the budget could be held at roughly their 1986 postsequestration levels in real terms. On the other hand, revenues would have to be increased significantly to their highest postwar levels ever. In 1991, revenues would amount to 20.3 percent of GNP--above the recent peaks of 20.1 percent attained in 1969 and 1981.

Revenue increases of this magnitude would require substantial changes in current tax policies--either sharp increases in individual and corporate income tax rates (see, for example, REV-01 through REV-03); sizable broadening of the tax bases (see REV-07 through REV-32); or the enactment of new taxes, such as a value-added tax (see REV-04).

Relying on Both Spending Cuts and Revenue Increases. A third general alternative to either sequestration or the Administration's proposal would be to adopt some mix of spending cuts and revenue increases. Such plans involve trade-offs between the value of services currently received and the burden of additional revenues required to sustain those services at their present levels. A mix of one-third revenue increases and two-thirds spending reductions to achieve the policy-related savings needed to eliminate the deficit by 1991 would require $28 billion in revenue increases and $55 billion in program cutbacks in that year (a 5 percent reduction relative to CBO's baseline projections). Under such a scheme, outlays and revenues would equalize at 19.4 percent of GNP by 1991. Reversing the ratio to rely on revenue increases for two-thirds of the policy-related deficit reductions would limit program cutbacks to less than 3 percent below CBO's baseline and would balance the budget at 19.8 percent of GNP.

Whatever the particular mix of revenue increases and spending cuts, spreading the burden of deficit reductions across both sides of the budget would make it possible to meet the deficit targets through more modest changes in current spending and taxing policies than if either outlays or revenues were placed off limits. Although most of the items contained in Section II would contribute little individually to achieving the deficit targets, they could be combined into such a broad-based alternative.

SECTION II

SPENDING AND REVENUE OPTIONS

HOW TO USE THIS VOLUME

This section of the report presents 127 policy options for reducing the deficit. Ninety-two of these options are in five major budget outlay categories--national defense (DEF), entitlements and other mandatory programs (ENT), agricultural price supports (AGR), nondefense discretionary (NDD), and personnel costs (PERS). Policy options that raise revenues (REV) account for the remaining 35.

For a listing of individual options under these categories, see the Table of Contents. For a listing of options grouped by budget function, see the Appendix.

Each option is presented in a standard format beginning with a table showing the budgetary savings calculated from the CBO baseline (in millions of dollars for spending changes and billions of dollars for revenue options). After the policy option is described, the major arguments for and against its adoption are given. CBO does not endorse or oppose any of the proposals. They are given simply as options to advance discussions of deficit reduction.

The proposals that follow are drawn from many sources, including recent legislative hearings, consultations with committee staff and other experts, and ongoing CBO analyses. To limit the size of the report, only options that would reduce the deficit by at least $1 billion over five years are reported. Because of this cutoff, many management issues and cutbacks in small programs are not discussed, although such initiatives may be desirable and feasible.

The reader should keep several cautions in mind. The savings effects of each option are calculated separately, as if none of the others were to become law. As a result of possible interactions among the options, however, the consequences of enacting a package would be different from enacting each option in isolation. Moreover, the enactment of some options would exclude the enactment of others. Thus, the separate options cannot be added to a grand total.

The deficit reductions discussed in this volume represent only a first approximation of savings that might actually be realized. Variations on any particular option could, of course, be used to vary the savings it might achieve. In some instances, a reduction in one program might result in the expansion of another program. For example, narrowing eligibility for VA hospital care would lead to some increase in Medicare outlays. In most cases, unless otherwise specified, such offsetting effects are not included in the estimates presented in this report.

In general, the estimated savings or revenue gains calculated for the deficit reduction options in this volume are derived from the economic assumptions underlying the CBO baseline. While reestimates would be necessary if different economic assumptions were used, the changes in numbers would generally not be major. Finally, the reader should keep in mind that estimates of deficits and policy changes that extend from one to five years in the future are subject to a margin of error.

NATIONAL DEFENSE

This section presents 25 options to limit spending for national defense. The first 13 alternatives offer lower spending levels by reducing the funds for procurement of major weapons systems, such as the MX missile, the F-15 aircraft, the Bradley Fighting Vehicle, and attack submarines. Savings would be achieved either by cancelling systems, as in DEF-01 and DEF-12, or by slowing the rate of procurement, as in DEF-02 and DEF-03.

Options DEF-14 through DEF-17 consider limits on spending in other investment accounts. Over the next five years, the Administration plans to spend large amounts in areas such as research and development and military construction. Options discussed here would achieve savings by reducing the rate of growth in these accounts.

Limits on growth in the military forces and on further improvements in readiness are discussed in DEF-18 through DEF-21. Although limiting the growth in the military forces would provide few savings in the first year, all the options would produce substantial savings once they were fully implemented.

Finally, DEF-22 through DEF-25 offer savings by limiting the growth in pay and benefits for military personnel. These include alternatives to raise military pay selectively (DEF-24) and to implement changes in the military retirement system for new members of the armed services (DEF-25). DEF-23 is concerned with the military health care system. Reductions in cost-of-living increases for retired military are discussed in option PERS-02 in the Personnel Costs section.

The estimates of savings from all options were made relative to the Administration's proposed 1987 budget, using CBO current economic assumptions. In most cases, savings are rounded to the nearest 100 million dollars and discussed in terms of budget authority rather than outlays.

DEF-01 AMEND THE ADMINISTRATION'S AIRLIFT PLAN

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	830	2,290	2,010	2,470	4,220	11,820
Outlays	340	850	1,360	1,550	1,900	6,000

The C-17 is a new, large military transport aircraft that can both fly long distances carrying large heavy loads, such as tanks and infantry fighting vehicles, and land on relatively short airfields. With these features, the aircraft can provide "strategic" airlift--that is, move troops and equipment from the United States to forward battle locations quickly. Partly because of its special capabilities, the C-17 will be expensive. The Air Force plans to procure 210 of these planes, beginning in 1988, at a reported procurement cost of about $110 million each in 1986 dollars.

According to the Department of Defense, U.S. forces currently do not have enough aircraft to provide the airlift that would be needed early in a conflict between the United States and the Soviet Union. Even with the addition of 44 KC-10s and 50 C-5s, which the Congress approved in 1982, available aircraft will fulfill only about 73 percent of the DoD airlift objective.

Strategic lift can be provided by ships. Although ships are slower--taking as long as 30 days to begin delivering cargo from the United States to Southwest Asia--both the Administration and the Congress have renewed their interest in sealift. Since 1982 the number of cargo ships in the U.S. Ready Reserve Force has increased from 27 to 72 through the acquisition of commercial ships. Some of these ships can sustain speeds of over 28 knots while carrying as much as 11,000 tons of military equipment--equivalent to nearly 230 loads on the C-17.

This option proposes to cancel the development and procurement of the C-17 aircraft, while continuing to invest in additional sealift. The proposal would save $830 million in budget authority in 1987 and $11.8 billion over the next five years, compared with the Administration's plan. Costs of continued procurement of sealift assets are already included in the Administration's plan and so would not offset these savings.

This proposal would adversely affect military capability only in certain types of wars. Current transport aircraft, together with the additional KC-10s and C-5s already approved, could provide sufficient airlift for the most likely contingencies. Only in the early weeks of a war involving the Soviet Union would the current airlift fleet be unable to meet the level deemed necessary by DoD. Moreover, some of the disadvantages of sealift in the early weeks of a war could be offset if loaded cargo ships began to deploy during periods of heightened tensions but before hostilities actually commenced. Also, the Army, the principal user of airlift, is reorganizing some of its existing divisions so that they will require fewer aircraft to transport their equipment.

Cancelling the C-17 is not, however, without its disadvantages. Some risk is associated with not having more aircraft in the event of a conflict with the Soviet Union. In addition to taking longer, sealift might not always be able to deliver cargo where it is needed because of unavailable or inadequate ports. Moreover, the adequacy of the current C-130 fleet to provide sufficient airlift over shorter distances has been questioned. (The C-130 is a smaller aircraft designed to move cargo within a wartime theater, whereas the C-17 is designed primarily to assist with long-distance transport.) Finally, much of the current airlift fleet is aging. Under current operating tempos, many of the C-141s and C-130s bought in the 1960s might have to be replaced by the end of the 1990s. Thus some of the savings from this option might eventually have to be devoted to replacing these aircraft. Furthermore, if the C-17 program is terminated now, resuming it later would, in all likelihood, mean paying higher costs.

Near-term savings associated with this alternative, however, are considerable. Moreover, savings would continue in the years beyond 1991, and even replacement of aging C-130 and C-141 aircraft in the 1990s should not consume all of them.

DEF-02 REDUCE CONSTRUCTION OF NEW SUBMARINES AND EXTEND THE SERVICE LIFE OF EXISTING SHIPS

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	1,040	160	1,510	1,020	940	4,670
Outlays	60	140	280	450	650	1,580

Although the Navy prefers to replace old ships with new ones, it has often retained ships beyond their usual service lives and, indeed, now plans to use this approach to attain the goal of a 600-ship Navy. Selectively extending the service lives of some submarines could permit a sizable reduction in shipbuilding budget authority annually without significantly affecting ship force levels. Cumulative five-year savings would be $4.7 billion. Obviously, though, such a course would affect the pace of fleet modernization.

From 1987 through 1991, CBO estimates that the Navy will retire about 13 attack submarines (10 nuclear-powered and 3 diesel-electric). The Navy plans to request funds to build 15 nuclear-powered SSN-688 class attack submarines and three new design SSN-21s. The average cost of each new SSN-688 class submarine will be about $640 million in fiscal year 1987 dollars, while the first SSN of new design will cost over $1.6 billion (later ships will cost less). Holding procurement of SSNs at the 1984 level of three per year, rather than the four now planned by the Navy, and extending the service life of an offsetting number of older submarines would save $4.7 billion in procurement costs over the five years.

Any reduction in the shipbuilding program would diminish the capability of the force and would be offset only partially by extending the service life of older ships. The older submarines mentioned above will have been in service about 30 years at their currently projected retirements. Nevertheless, although the older submarines are less capable than the new SSN-688s, they can still perform a broad range of useful missions.

DEF-03 CANCEL OR REDUCE PROCUREMENT OF THE F-15

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Freeze Annual Procurement at 36						
Budget Authority	400	400	400	400	400	2,000
Outlays	30	170	280	320	350	1,150
Cancel the F-15						
Budget Authority	2,240	2,240	2,260	2,100	2,100	10,940
Outlays	250	1,000	1,540	1,790	1,900	6,480

The F-15 is the Air Force's premier fighter, capable of operating during day or night and in inclement weather. Its long-range radar and medium-range missile enable the F-15 to attack enemy aircraft before those aircraft can detect and attack the F-15. Because of the F-15's expense, however, the Air Force developed the less capable but cheaper F-16 to fulfill its total force requirements. The Congress cut F-15 procurement from 48 to 36 planes in 1984 and from 48 to 42 in 1985. DoD proposes to buy 48 per year from 1987 to 1991.

Freeze Annual Procurement at 36. By limiting further procurement to 36 F-15s annually, this option would save $400 million in budget authority in 1987 and $2 billion over the next five years. Current Air Force plans entail procuring more F-15s and F-16s, in part to replace older F-4s, most of which will reach the end of their usual service life of 20 years by the late 1980s. Limiting F-15 procurement should not affect the Air Force's planned expansion as the Administration's current plan would procure more than enough fighter aircraft to meet its 40-wing force goals.

Cancel the F-15. Alternatively, further procurement of the F-15 could be cancelled. This option would save $2.2 billion in budget authority in 1987 and $10.9 billion over the five-year period. Without offsetting increases in F-16 purchases, however, the Air Force would be unable to expand to its planned size unless F-4s were kept until they were 22 years old--a rather short extension of their service lives. Cancellation would also reduce overall capacity to produce aircraft. Furthermore, it would foreclose the option of procuring the F-15E, an improved version of the F-15 that the Air Force is now buying for its ground attack mission.

DEF-04 CANCEL THE ARMY HELICOPTER IMPROVEMENT PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	250	240	350	380	350	1,570
Outlays	40	140	220	290	330	1,020

The Army Helicopter Improvement Program (AHIP) is an interim modification program to extend the usefulness of existing OH58 scout helicopters. The Army also plans to procure a new light helicopter (the LHX) in the 1990s to fulfill, among other things, the scout helicopter mission. Cancelling the remainder of AHIP and waiting for the new helicopter could save an estimated $250 million in budget authority in 1987 and $1.6 billion over the next five years.

A scout helicopter's primary mission is to identify and designate targets for artillery. The modification program improves both the OH58's ability to accomplish this mission--by installing infrared sensors and laser range finders--and the survivability of the helicopter itself--by mounting the sensors above the blade rotor, thus enabling the body of the helicopter to remain hidden behind trees or hills. Funds authorized through 1986 will modify almost 100 helicopters, and the planned AHIP program would improve another 48 helicopters in 1987 and a total of 496 by 1991. Concurrently, the Army is preparing for full-scale development of a new fleet of helicopters (the LHX) that will be better equipped to serve as scouts.

If the remainder of AHIP were cancelled, the Army would have to rely more heavily than planned on the current OH58 scout helicopter until the new fleet of scout helicopters is deployed in the early 1990s. In recent Army operational tests, however, AHIP-equipped helicopters showed little improvement in performance over that of the existing OH58 helicopters, thus casting doubt on the need for the AHIP program. Some "safety-of-flight" modifications might still be required for the OH58 helicopters, resulting in a slight reduction of the savings shown above.

DEF-05 CANCEL PROCUREMENT OF AQUILA REMOTELY PILOTED VEHICLE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	140	190	170	40	20	560
Outlays	10	60	130	150	110	460

The Aquila Remotely Piloted Vehicle (RPV) is a small, fixed-wing drone aircraft, designed to perform target acquisition and laser designation of targets within a range of 45 kilometers. It is launched from a rail assembly mounted on a five-ton truck chassis, and is recovered with a large net mounted on a similar chassis. The RPV's flight path is governed either by line-of-sight communication through digital control or by preprogramming the flight plan. Although the Army plans for the Aquila to enter the force in 1989, many operational problems have not yet been resolved.

While the Aquila would be the first RPV fielded by the Army in significant numbers, the Army already deploys other systems that can perform roughly the same tasks although not necessarily to the same degree as the design specifications of Aquila. Indeed, by 1990 the Army plans to field more than 1,000 Ground Locator Laser Designators (known as GLLDs) and more than 1,000 helicopters capable of target reconnaissance, identification, and laser designation--all functions of Aquila. Moreover, only two Army munitions--the Copperhead (launched by 155-mm howitzers with ranges of roughly 18 to 24 kilometers) and the Hellfire missile (launched by attack helicopters)--can engage targets designated by laser.

Because of its bulky launch and recovery vehicles, the Aquila is difficult to transport. Since the C-5 is the only transport aircraft that can carry assembled Aquila support equipment, only a few planes would be available to transport the Aquila quickly to a combat zone. Deployment in the more numerous but smaller C-141 or C-130 aircraft could be accomplished only after a major, time-consuming disassembly. Furthermore, the Army does not plan to assign many Aquilas to its operating units. Although it intends to purchase 376 Aquila vehicles, only 117 will be deployed in nine batteries, to support the five active Army Corps. The remaining 259 vehicles are earmarked for training, war reserve stocks, and replacements of peacetime losses.

By eliminating the procurement of the Aquila and maintaining only a research and development effort, this option would save $140 million in budget authority in 1987 and as much as $0.6 billion over the next five years, assuming procurement of any RPV system is delayed that long. Additional savings, not included here might be realized if the Army did not hire the roughly 700 people needed to support Aquila.

This option would clearly delay fielding of an RPV. But the Army could continue to test and evaluate Aquila and alternative RPV systems, such as the Lear Siegler Skyeye, the Israeli Mastiff, or the Canadian Sentinel. Indeed, the Army is currently considering a family of RPVs that might include some or all of these other systems.

DEF-06 CANCEL V-22 AIRCRAFT DEVELOPMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	390	590	790	1,190	1,890	4,850
Outlays	200	400	300	450	850	2,200

The V-22, previously known as the JVX, is a new tilt rotor aircraft under development by the Department of the Navy for use by all four services. (Tilt rotor means that the aircraft has rotor blades that can be positioned vertically for taking-off and landing and horizontally for forward flight.) The aircraft will be designed to transport 24 people or about 5,700 pounds of equipment at cruising speeds of over 280 miles per hour. Its long maximum range of 2,400 miles should allow it to fly to Europe, in the event of war, thus freeing large transport aircraft and amphibious ships for other cargo.

The aircraft is expected to perform different missions for each of the four services. The Marine Corps has expressed the largest and earliest need, asking for 552 aircraft with delivery beginning in the early 1990s. These aircraft would be used for combat assault--that is, transporting troops and equipment from an amphibious ship to a beachhead--a mission currently being fulfilled by the aging CH-46 and CH-53 helicopters. Air Force requirements call for 80 aircraft in the 1990s for special operations, while the Navy has indicated a need for only 50 aircraft to conduct combat search and rescue. Army requirements are the least precise of all the services. Recently, the Army indicated that it would procure about 231 aircraft in the mid-1990s, possibly for transporting cargo.

Despite these potential uses, missions planned for the V-22 could be performed by other aircraft. Moreover, the V-22 is an expensive development program; Navy cost estimates range from $2.4 billion to as high as $3.1 billion. Procurement costs would add substantially to the total. Introduction of the V-22 could also reduce the number of other Navy aircraft purchased, if defense budgets do not enjoy the levels of growth experienced in the early 1980s. In fact, the Congress is already concerned about the number of Navy aircraft programs currently funded at low procurement rates.

Further development and procurement of the V-22 could be cancelled, saving an estimated $390 million in budget authority in 1987 and $4.9 billion over the next five years. The Marine Corps could continue to rely on the older and less capable CH-46 and CH-53 helicopters currently being used, while considering other helicopters and amphibious landing craft to perform the combat assault mission in the future. Relying on these older helicopters should not cause operational problems at the present time. The Marine Corps has indicated that, by continuing to replace parts subject to wear, helicopter service lives can be extended indefinitely.

DEF-07 CANCEL E-6 AIRCRAFT PROCUREMENT

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	410	380	360	300	10	1,460
Outlays	70	200	270	300	280	1,120

In the event of nuclear war, the Navy proposes to use E-6 aircraft to provide enhanced communications between the National Command Authority and submarines that carry ballistic missiles. The Navy plans to buy 12 E-6s to replace the EC-130 aircraft that currently perform this mission. Although a substantial developmental effort is still required to adapt the EC-130 communications suite to the E-6--a military variant of the commercial Boeing 707--the Navy plans to fund procurement of most of these aircraft before development and operational testing is completed.

Justification for the E-6 aircraft rests primarily on its ability to stay aloft longer than the EC-130, thus allowing it to operate out of a greater number of dispersed bases, and so lessen the aircraft's vulnerability to enemy attack in time of nuclear alert. This will become more important with the introduction of the Trident II missile on submarines in the Pacific. The greater range of the missile could increase the operating area available to the submarine, thus increasing the desirability for an aircraft that can travel farther while still using all of the available dispersed bases.

The E-6 is expensive, however, with a unit program cost of nearly $140 million (in fiscal year 1987 dollars). The Congress has raised concerns about the affordability of the aircraft now, especially since the EC-130 apparently can satisfactorily perform its mission for several more years, with only modest loss in capability as the Trident II missiles gradually enter the fleet.

Deferring E-6 procurement until the early 1990s would save $410 million in budget authority in 1987 and $1.5 billion over the next five years. This option would allow the Navy to test the program before actual procurement begins. The Navy could also examine alternative and, possibly, more affordable programs. As more Trident II missiles enter the fleet, however, the costs to operate the EC-130 fleet could increase as the aircraft must fly farther to service the greater area covered by the new missile. The EC-130 would also provide less overall capability than would the E-6 program. Thus, eventual replacement of the EC-130 might be desirable.

DEF-08 CANCEL M9ACE ARMORED COMBAT EARTHMOVER

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	30	160	100	100	120	510
Outlays	2	20	75	100	100	297

The M9 armored combat earthmover (ACE) is designed to provide engineering support to the Army's armored, mechanized, and light infantry battalions. The Army now uses an unarmored D7 bulldozer that offers the operator little protection from enemy artillery or small arms fire and that cannot move far without truck transport.

One of the primary tasks of this support vehicle is to prepare firing positions for tanks and infantry fighting vehicles (IFVs). This involves digging one or two holes in which each combat vehicle can park, thus enabling them to remain partially concealed while firing their guns. The Army believes that the M9ACE can perform this mission more quickly than the D7 bulldozer and with increased survivability and mobility. Despite its extra armor, however, the M9ACE remains highly vulnerable to enemy fire from tanks or large caliber weapons. As a result, it is likely to be used only when there is little or no threat from direct enemy fire and artillery, thereby making armor protection unnecessary.

It is also unclear whether the M9ACE needs to be self-mobile. Each maneuver battalion would be supported by four earthmovers. Four earthmovers could not accompany a fighting force of 60 to 70 vehicles as it retreats or advances and dig enough holes (60 to 140 to provide one or two per vehicle) to enable the force to occupy a tenable position rapidly. Rather, firing positions need to be prepared in advance, thus negating the need for the earthmovers to move with the force.

This option would cancel further procurement of the M9ACE, saving \$30 million in budget authority in 1987 and a total \$510 million over the next five years, and continue to rely on the D7 bulldozer. Without the need for armor protection or self-mobility, the current D7 bulldozer can provide combat engineering support to mechanized and armored battalions but at some greater risk to the operator. Alternatively, the Army could seek to provide much of this same support by equipping U.S. tanks with bulldozer blades, as the Soviet Union has done, thus enabling each tank to prepare its own firing position. This would create an extensive and responsive combat engineering capability, while decreasing some logistics support. A small portion of the savings shown above could be dedicated to modifying the planned M1 tank fleet.

DEF-09 CANCEL THE ADVANCED MEDIUM-RANGE, AIR-TO-AIR MISSILE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	810	1,080	1,170	1,110	900	5,070
Outlays	210	510	760	900	900	3,280

The advanced medium-range, air-to-air missile (AMRAAM) is a radar guided missile planned for use by fighter aircraft of the Air Force, Navy, and Marine Corps. It will replace the Sparrow AIM-7 missile currently used by the services for longer-range, air-to-air engagements. AMRAAM, which is designed to be lighter than the Sparrow, will have a longer range and a higher speed. It will also have a "launch-and-leave" ability that will enable attacking aircraft to disengage after firing the missile in order to protect themselves and to seek other enemy targets. The current Sparrow missile must be guided to its target by the launching aircraft, thus leaving the plane vulnerable to enemy attack.

AMRAAM has, however, experienced problems both with cost and performance. Since the program's inception, cost per missile has tripled, growing from $150,000 in 1979 to about $450,000 now in current dollars. The program is also more than two years behind schedule. Indeed, AMRAAM's woes attracted the attention of the Secretary of Defense, who last year gave the Air Force notice that the program would be cancelled if costs were not brought under control. Moreover, the contractor has had difficulty integrating the target tracking mechanism into the smaller production versions of the missile, requiring reductions in radar power to avoid electrical interference. The Air Force claims recent tests show that these problems have been largely overcome, although the testing program might be at too early a stage to decide this conclusively.

The Congress has also repeatedly expressed doubts about the missile. In considering the fiscal year 1986 budget, the Senate Armed Services Committee, citing concern about the cost of the missile, reduced funding. The House Armed Services Committee described the AMRAAM program as the "single most vivid example of what is wrong with the defense acquisition process" and deleted all funding. The conferees agreed to provide less than half the funds requested and required the Department of Defense to report on the affordability of the program before the funds can be expended. The House Appropriations Committee provided no funds for the program in 1986, arguing that the program was so far behind schedule that funds already appropriated could be used.

The Congress could elect to cancel AMRAAM because of its increased cost and potentially reduced effectiveness. This would save $810 million in budget authority in 1987 and $5.1 billion over the next five years. The services would continue to rely on the less expensive, albeit less capable, Sparrow missile. Although this missile does not have the planned capabilities of AMRAAM and cannot be used by the Air Force's current F-16 fighters, it offers some ability to attack even the best Soviet fighter aircraft. Furthermore, some argue that air-to-air combat is most likely to take place at closer-in, visual range where the existing Sidewinder missile would be effective.

DEF-10 DELAY ADVANCED TACTICAL FIGHTER (ATF) DEVELOPMENT

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	290	340	580	700	2,400	4,310
Outlays	150	280	440	590	1,420	2,880

The Air Force plans for the advanced tactical fighter (ATF) to be its next premier fighter, replacing the F-15 in the mid-1990s. According to development design, the plane should have stealth characteristics and supersonic cruise speed. Improvements in avionics and short take-off and landing ability should make it more versatile than current fighters. Finally, advancements in reliability, maintainability, and survivability should hold down its operating and support costs while increasing availability.

Although desirable, these enhancements will be costly. Development will cost $4.7 billion over the next five years alone. The Air Force currently projects that the plane's flyaway procurement cost--the cost excluding initial spares and ground support equipment--will be about 70 percent greater than that of the F-15 after adjustment for inflation. Historical cost analysis indicates that this estimate might be low. The F-15, for example, was about 200 percent more costly than the F-4 fighter it replaced.

The House Armed Services Committee reduced 1986 funding for the project and questioned its affordability. The committee was also concerned that some new technology might not be available in time to provide planned improvement in capabilities. The Senate Appropriations Committee, concerned about the effect of cost on force size, instructed the Air Force to limit the fighter's procurement cost.

The Congress could decide to defer development of this aircraft until the 1990s, choosing instead to rely on existing F-15s plus the new F-15E scheduled to enter the force in 1988. This would save $290 million in budget authority in 1987 and a total of $4.3 billion over the next five years, while allowing some technology development programs to mature. Deferring the ATF development would, however, delay fielding a new-generation fighter until the next century and could increase the risk that Soviet efforts would produce a fighter with a greater capability than U.S. fighters.

DEF-11 DELAY PROCUREMENT OF TRIDENT II MISSILE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	1,430	2,290	2,300	2,300	1,670	9,990
Outlays	150	750	1,480	1,940	2,070	6,390

NOTE: Department of Energy costs for nuclear warheads are excluded from this analysis.

The Trident II submarine-launched ballistic missile (SLBM), the successor to the Trident I SLBM, will be deployed in new Trident submarines starting with the ninth ship in December 1989. This missile will have greater accuracy and carry larger warheads than the Trident I missile, thus providing considerably improved capability against hardened targets. The first research and development test flight of the missile is scheduled for January 1987.

Although the Trident II offers significant improvements over the Trident I, it is expensive. The total estimated cost of the missile program is $38 billion in current dollars, making it the most expensive ballistic missile program ever undertaken by the United States. The Congress could choose to reduce the funding for the Trident II program and delay initial deployment of the Trident II missile until 1994 when the fifteenth Trident submarine is scheduled to enter the fleet. This would result in savings of $1.4 billion in budget authority in 1987 and $10 billion from 1987 through 1991.

Deferring Trident II procurement would impose continued reliance on the Trident I missile. In order to obtain enough Trident I missiles to equip the six additional Trident boats, some Poseidon submarines carrying Trident I missiles would have to be retired early. To compensate, the life of Poseidon submarines carrying Poseidon missiles could be extended. Trident submarines currently under construction would require some modification to accommodate the Trident I missile rather than the planned Trident II missile. Furthermore, overhauls scheduled for Trident submarines before 1994 would be deferred for two years. As with the current plan, all Trident submarines with Trident I missiles would be converted to Trident II missiles during overhaul, resulting in a total of 20 Trident submarines with the Trident II missiles.

DEF-12 CANCEL THE BRADLEY FIGHTING VEHICLE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	800	630	340	280	0	2,050
Outlays	20	370	530	450	340	1,710

The Army's M2 Bradley Fighting Vehicle (BFV) was designed to accompany and keep pace with the M1 Abrams tank on the battlefield. The M2 can carry nine infantry personnel while also providing firepower from a TOW antitank missile and a 25-mm automatic cannon. The M2 is an improvement over the old M113 personnel carrier, which also provided armored protection for infantry squads but had little offensive striking power of its own. The Congress has already authorized the purchase of more than 3,600 Bradleys.

Recently completed Army tests have revealed that this lightly armored vehicle, when fully fueled and loaded with ammunition, will explode violently if antitank munitions strike it in certain places--a not unexpected result. The Army believes that it can minimize the Bradley's vulnerability by using terrain to provide protection from direct enemy fire and by allowing tanks to precede the M2s in an attack against forces with antitank weapons. Furthermore, it is considering a modification program designed to reduce the vehicle's vulnerability to catastrophic explosions. The proposed modification program might add as much as $75,000 to the cost of each vehicle, which is about $1.5 million.

Although the Bradley packs much more firepower than its 1960s predecessor, it costs seven times as much as the M113. According to the Army, part of the justification for the increased capability--and the associated cost--was the need for a vehicle that could keep up with and fight side by side with the M1 tanks. This tactic, however, would unduly expose the Bradleys to antitank weapons that are now widespread throughout most enemy forces thus allowing the enemy to exploit the Bradley's vulnerability. More conservative tactics emphasizing the BFV's ability to engage targets from long distances would reduce the carrier's vulnerability and still exploit its potential. A less sophisticated alternative, though, might be able to fulfill the same role at less cost.

For example, significant savings could be realized by purchasing upgraded M113s and Improved Tow Vehicles (ITV) in place of Bradley M2s. The modified M113 would be equipped with an improved transmission and engine, a turret, and a 25-mm cannon; the ITV is an M113 with TOW-II missiles. The total firepower of 3,200 Bradleys could be achieved by 3,200 modified M113s and 2,000 ITVs . (Each Bradley carries 7 TOW missiles, while ITVs carry 12 TOW missiles. Thus, 2,000 ITVs provide about the same antitank capability as 3,200 Bradleys, while the modified M113s provide roughly the equivalent cannon capability.) This alternative offers savings of about $800 million in budget authority in 1987 and $2.1 billion over the next five years, relative to the Army's plan, which would buy over 3,200 Bradleys.

The modified M113s and ITVs would not have the same ground mobility as the Bradley, however, and, therefore, would not be able to keep up with the M1 tanks over most terrain. Also, the M113 and ITV are at least as vulnerable to enemy antitank munitions as the Bradley itself. In light of the increasing antitank threat, however, prudence would dictate that, when possible, armored personnel carriers should not be employed alongside main battle tanks. Furthermore, fielding TOW launchers and 25-mm cannons on separate vehicles would afford the battle commander greater flexibility in the deployment of his weapons. The 3,600 Bradleys already purchased could be used primarily as reconnaissance vehicles in armored cavalry or scout units.

DEF-13 REDUCE MX TEST MISSILES

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	600	1,500	1,400	1,200	270	4,970
Outlays	140	540	920	1,100	890	3,590

The Congress put at least a temporary end to debate over deployment of the MX missile, which carries 10 nuclear warheads, by specifying in the fiscal year 1986 authorization bill that no more than 50 missiles were to be deployed in existing Minuteman silos. The Administration, however, in its 1987 defense plan, has not reduced either the size or the total system cost of the MX. The Administration still plans to implement an alternative basing mode for an additional 50 missiles and has retained the original size of the missile test program, which is independent of the total number of deployed missiles. Of the total 243 MX missiles in the Administration's plan (including research and development missiles), 143 are designated exclusively for testing. Of the remaining 169 missiles that the Administration plans to buy, 119 are earmarked for the test program.

The purpose of the test program is to establish the missile's capability and reliability and to monitor those attributes over the course of its operational life of about 15 years. The Joint Chiefs of Staff (JCS) has furnished statistical guidelines that specify the size of an acceptable test program. The current MX test program is generally consistent with those guidelines and is modest compared with test programs for past generations of U.S. ballistic missiles. Nonetheless, in light of fiscal constraints and the small size of the planned MX deployment, the Congress might consider a much smaller operational test program that would save money at the expense of added risk.

This option assumes that the Congress will allow deployment of only 50 MX missiles and will not consider alternative basing modes for the additional 50 missiles contained in the Administration's plan. Furthermore, this option provides for minimal testing of the MX and would purchase only 47 missiles--36 for the entire Operational Test (OT) program and 11 more to test the effects of aging on the missiles. This would be 72 fewer new test missiles than are now planned. The Air Force would determine the allocation between the early phase of operational testing--to establish baseline missile performance parameters--and the later phase--to monitor for declines in reliability. To achieve the total number of missiles, annual production would be limited to no more than 12 missiles per year in each of the next four years. Savings under this option would be $600 million in budget authority in 1987 and $5.0 billion over the five years. Alternatively, the Congress could continue MX procurement at a rate of 21 missiles per year, thus completing procurement by 1989. This procurement schedule would achieve no savings in budget authority in 1987 but would save $4.8 billion by the end of the 1987 through 1991 period.

This option might be consistent with the belief that the limited contribution of 50 deployed MX missiles--generally carrying less than 1 percent of survivable U.S. warheads--does not warrant the expense of heavy testing. It could substantially increase risk, however. Thirty-six OT test missiles would not permit the Air Force to meet JCS guidelines both for establishing missile baseline performance parameters and for monitoring missile reliability.

DEF-14 ALTER FUNDING FOR SUPPORTING PROCUREMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Limit 1987 Funding to Zero Real Growth						
Budget Authority	3,600	3,400	3,700	3,900	4,200	18,800
Outlays	1,300	2,100	2,900	3,400	3,700	13,400
Limit 1987 Funding to Zero Nominal Growth						
Budget Authority	4,400	3,800	5,200	5,900	6,700	26,000
Outlays	1,500	1,900	3,200	4,200	5,200	16,000

Most public debate over the defense budget revolves around large weapons systems such as missiles, aircraft, and ships. Acquisition of such weapons accounts for about 79 percent of total procurement appropriations. The remaining 21 percent--labelled here as "supporting procurement"--is spent for trucks and cars, communications equipment, general purpose computers, office equipment and furnishings, training devices, and the variety of other equipment required by the military services. These items support the operational needs of the services both in the field and at headquarters. In terms of mission importance, they range from items essential to military operations, such as trucks and radios, to items more related to administrative activities common to peacetime and wartime, such as office computers.

Limit 1987 Funding to Zero Real Growth. In 1986 the Congress limited the Administration's request for an 8.5 percent real increase in budget authority for supporting procurement to about 1 percent. The Administration has requested a real increase of 17.8 percent for supporting procurement in its 1987 budget. The increase for 1987 could again be limited to an amount sufficient to offset the effects of inflation; these accounts could then be allowed to grow by the rate proposed by the Administration in subsequent years. This reduction would save $3.6 billion in budget authority in 1987 and $18.8 billion over five years.

Because these accounts buy a multitude of equipment items, this report cannot specify the detailed changes needed to achieve the savings discussed above. In the past, the Congress has tended to cut funds for communications equipment, munitions, and industrial preparedness by larger amounts, while providing most of the requested funds for items such as spare parts, vehicles, and base support equipment. If this pattern was followed in limiting the 1987 request, the major effects would be a slowing of communications modernization and less ability to sustain combat in the event of an extended conflict. Normal peacetime operations and immediate combat readiness would be less affected.

Limit 1987 Funding to Zero Nominal Growth. Alternatively, budget authority for supporting procurement could be frozen at the 1986 level for one year and only allowed to grow with the amount of inflation in subsequent years. This would save $4.4 billion in budget authority in 1987 and $26 billion over the next five years. Because the 1987 appropriation would contain no adjustment for inflation and subsequent appropriations only an inflation adjustment, this approach would reduce the real level of funding below the 1986 level by about 4.1 percent. This approach could adversely affect peacetime operations and, perhaps, lessen U.S. ability to sustain combat in an extended war. Again, however, it is difficult to assess the exact effects of a reduction in such a diverse budget area.

DEF-15 ALTER RESEARCH AND DEVELOPMENT FUNDING

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Reduce 1987 Funding Request by 10 Percent						
Budget Authority	4,200	4,200	4,100	4,200	4,700	21,400
Outlays	2,100	3,600	3,900	4,000	4,300	17,900
Limit Funding to Real 1986 Level						
Budget Authority	7,500	6,300	4,100	3,100	6,200	27,200
Outlays	3,800	5,900	4,800	3,600	4,700	22,800

Research, Development, Test and Evaluation (RDT&E) funding for the Department of Defense pays for a wide range of activities: basic research, such as high-energy physics or microbiology; applied research, such as ceramic or construction engineering; engineering development to put weapons systems into production; and testing programs for potential weapons or experimental designs. Although most defense RDT&E funds are spent in private industry for the development of weapons systems, these funds also finance the operation of government laboratories and much research activity at universities and private nonprofit research centers.

The adequacy of RDT&E funding and the potentially adverse effects on research brought about by lower than planned spending levels are difficult to measure. Much of the research funding is spent to explore new technologies, only some of which lead to advanced research and development. Increases in real levels of research funds should allow continued exploration of new areas; lower spending levels would require greater scrutiny of new research proposals and harder choices about the continued funding and rate of funding for ongoing programs. At some point, tighter research budgets would result in a narrowing of the U.S. technological advantage over the Soviet Union.

Reduce 1987 Funding by 10 Percent. RDT&E budget authority has grown sharply in recent years, up by 74 percent in real terms from 1980 through 1985. This corresponds to average annual real growth of about 12 percent.

Although the Administration requested a 25 percent real increase in funding in 1986, the Congress appropriated about 10 percent fewer funds than the Administration requested.

For 1987 the Administration has requested 22 percent real growth in budget authority for RDT&E. The Congress could choose to reduce RDT&E funding by 10 percent in 1987 and then allow it to grow at the rate proposed by the Administration in subsequent years. This would save $4.2 billion in budget authority in 1987 and $21.4 billion over the next five years. This option would allow a real increase of about 10 percent in 1987 and would leave RDT&E with about 12 percent of the entire defense budget, a high level by historical standards.

Because so many programs exist in this area, this report cannot specify which programs would be affected by a slowdown. Last year, for example, the Congress made detailed changes to hundreds of different RDT&E programs. The Strategic Defense Initiative (discussed in DEF-16) and research on a new, small ICBM would probably be affected by any major slowdown in RDT&E funding, as would many smaller programs.

Limit Funding to Real 1986 Level. Alternatively, the Congress could hold 1987 RDT&E budget authority to no real growth in each of the next five years. This approach would save $7.5 billion in budget authority in 1987 and $27.2 billion over the next five years. Savings of this magnitude, however, could not be achieved without some restructuring of the RDT&E plan proposed by the Administration. Major research programs would have to be slowed and some lower priority programs probably would be terminated to allow continued funding of programs that enjoy a higher priority.

DEF-16 SLOW GROWTH IN THE STRATEGIC DEFENSE INITIATIVE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	1,100	1,300	1,500	1,800	2,100	7,800
Outlays	500	1,040	1,290	1,550	1,830	6,210

On March 23, 1983, President Reagan called for the United States to render nuclear weapons "impotent and obsolete" by developing defenses that could destroy an enemy's nuclear weapons before they exploded on American soil. The research and development (R&D) plan resulting from this mandate--known as the Strategic Defense Initiative (SDI)--calls for devoting about $33 billion from 1987 through 1991 to study applicable technologies and system concepts, ranging from space-based lasers and particle beam weapons to more conventional antiballistic missiles (ABM).

The planned budget calls for a steep rate of real growth in SDI funding: 68 percent from 1986 to 1987, and an average of 14 percent annually thereafter through 1991.. Thus, the SDI will consume a greatly increasing share of Department of Defense R&D resources. In 1985, the first year of the SDI program, it represented about 5 percent of the Research, Development, Test, and Evaluation budget. By 1991 the SDI would take up about 19 percent of the total DoD research budget. In view of this increase, the Congress has expressed concern about the efficient use of these fast-growing funds, as well as the impact SDI funding might have on other important R&D programs. Some members of the Congress have questioned SDI development since it depends heavily on technological breakthroughs and since pressure to proceed beyond research could lead to abrogation of the ABM treaty, thus fueling an arms race in space with the Soviet Union.

Efficiency and technological concerns could be partly addressed by spreading the spending proposal (in real terms) for the next five years over six years. This slowdown would save $1.1 billion in budget authority in 1987 and $7.8 billion over the next five years. Under this plan, however, the SDI would still consume about 16 percent of the DoD research budget by 1991. Remaining funding should allow intensive evaluation of the feasibility of new SDI technologies. Full-scale development and deployment decisions could still be pursued in the 1990s, although with some delay. This slowdown would also allow more time to develop this large program efficiently and to debate fully the technical and arms control issues involved in these efforts.

DEF-17 ALTER FUNDING FOR MILITARY CONSTRUCTION

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	1,500	3,500	3,300	4,500	4,100	16,900
Outlays	200	1,100	2,200	3,000	3,700	10,200

Military construction funding for the Department of Defense pays for a wide range of activities: combat-related construction, such as ammunition storage facilities and aircraft and weapons maintenance facilities; morale- and welfare-related construction, such as gymnasiums and child care centers; and living accommodations, such as barracks and housing for unaccompanied personnel. These funds also pay for acquiring land for military use and for modifying existing facilities.

Military construction funding increased by an average of 14 percent per year in real terms from 1980 through 1985. In 1986, however, the Congress restricted budget authority for military construction to about 4 percent below the 1985 nominal level. In 1987, DoD has asked for $6.8 billion for military construction, a real increase over the 1986 level of 24 percent. If this request was restricted to the nominal 1986 level, and held constant in real terms in subsequent years, this option would save $1.5 billion in budget authority in 1987 and $16.9 billion over the next five years.

Potentially adverse effects of continuing to limit the growth in military construction are difficult to assess because of the large number of projects in this area, each of which could be affected differently. Some projects would likely take longer to complete, while some planned military construction programs would probably be cancelled or postponed indefinitely. Even some new projects that have received strong support from the services--such as military construction programs at Ft. Drum, New York, and in Alaska to support the Army's new divisions and the Navy's plan to establish new homeports for some of its fleet--might have to be reduced in scope unless spending for other projects was lowered to offset the cost of the new programs.

DEF-18 SLOW INCREASES IN THE TACTICAL AIR FORCE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	0	170	540	940	1,180	2,830
Outlays	0	90	320	620	860	1,890
Savings in Defense Budget a/						
Budget Authority	0	170	540	940	1,180	2,830
Outlays	0	110	380	720	980	2,190

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

The Administration announced in 1981 that it intended to increase the Air Force tactical fighter force from 36 air wings to 40 wings by 1986, with a further increase to 44 wings by the early 1990s. (A typical wing consists of 72 combat aircraft with 28 back-up aircraft for training and maintenance.) The competing pressure to modernize the force, however, has led the Air Force to postpone these increases so that it had added only one new wing by 1986. Current plans are to field 40 wings by 1991, with no announced expansion planned beyond that year. Additionally, the Congress has expressed some reservations about the 40-wing force. In its 1985 report, the Senate Appropriations Committee indicated that it supported modernization but not necessarily an expansion of the existing force. And the House Armed Services Committee expressed concerns about the affordability of the 40-wing goal in its 1986 report.

The Air Force believes that the increase in both quality and quantity of Soviet aircraft pose a growing threat. Modernization of U.S. forces without force expansion, therefore, might not be sufficient to maintain the current balance between U.S. and Soviet tactical air forces, while simultaneously meeting the expanding global commitments desired by the Administration.

On the other hand, the Air Force has been willing to accept any risks inherent in slowing force expansion in recent years as it delayed growth in favor of buying modern aircraft for existing wings. If the force expansion planned by the Air Force were delayed beyond the next five years, thus maintaining the current 37 wings at least through 1991, the projected manpower and operational support requirements would be decreased over this period as well. Although no savings in budget authority would be realized in 1987 by slowing the expansion, $2.8 billion could be saved by 1991, compared with the Administration's plan. Moreover, a decision to delay expansion now would allow for reductions in aircraft purchases during the next several years (see DEF-03).

DEF-19 PLACE THREE CARRIER BATTLE GROUPS IN RESERVE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	0	70	210	330	420	1,030
Outlays	0	50	140	230	300	720
Savings in Defense Budget a/						
Budget Authority	0	70	210	330	420	1,030
Outlays	0	60	190	310	400	960

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

As a major feature of its defense program, the Administration plans to increase the number of aircraft carriers in the Navy's active fleet from 13 to 15. This expansion would also necessitate a commensurate increase in the number of carrier air wings, escort ships, and support ships. Some observers, however, believe that a force of 15 carriers is not required and that 12 would be adequate. A middle ground between these two positions would be to maintain a force of 12 carriers in the active fleet and assign three carriers--along with their associated air wings, escorts (about six per carrier), and support ships--to a special category of the Naval Reserve Force. Although no savings in budget authority would be realized in 1987 by adopting this option, about $1 billion could be saved by 1991, compared with the Administration's plan.

These reserve ships would be manned with reduced crews of active-duty personnel, about 50 percent or less of the ship's normal complement, to perform basic maintenance. The remainder of the crews would be in the reserves. These ships would not go to sea unless mobilized, and assignment to one would count as shore duty in sea/shore rotation. The reserve personnel in this option would be placed in special, nondrilling status. To ensure their proficiency, these reserves would be assigned to the carrier group only for a short period--probably a few years--after they left active duty. Arguably, their skills would not have atrophied greatly in that short period.

Unlike inactive reserve (mothball) ships, these ships would be given periodic overhauls and updated with modern equipment.

This option would also change the Navy's current plans for building to 14 active air wings and two reserve wings to maintaining 12 active wings and, eventually, three reserve wings. (An air wing consists of about 90 aircraft per carrier plus associated equipment and personnel.) Reserve air wings would be manned at current levels, which would permit the substantial peacetime training necessary to maintain flying skills. Carrier training for the reserve wings would be conducted on active-duty ships, as is done now, and reserve wings would continue to receive modern aircraft. This option would not alter current procurement plans, however, since the ships and wings in both the active and reserve forces would be modernized.

DEF-20 RETIRE SOME G-MODEL B-52 STRATEGIC BOMBERS EARLY

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	270	840	1,180	1,240	1,300	4,830
Outlays	130	470	780	940	1,050	3,370
Savings in Defense Budget a/						
Budget Authority	270	840	1,180	1,240	1,300	4,830
Outlays	150	540	880	1,050	1,160	3,780

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

The bulk of the current strategic bomber force consists of the G and H models of Boeing B-52 aircraft, introduced into the force in the 1960s. Continuing improvements in Soviet air defenses have limited the ability of these bombers to penetrate Soviet airspace. To address this problem, the Administration plans the installation of air-launched cruise missiles on B-52s, the fielding of 100 new B-1B bombers, and introduction of an advanced technology--or "stealth"--bomber (ATB) at a later time.

Cruise missiles are small, unmanned missiles that are highly accurate and can be launched outside Soviet airspace, thus allowing the bomber to remain beyond the range of most enemy air defenses. Cruise missiles are now deployed on 90 of 151 B-52G aircraft, and the 90 newer B-52H aircraft are being modified to carry these missiles. B-52Gs not modified to carry cruise missiles will be transferred from the strategic forces and used as conventional bombers.

The Administration plans to retire B-52Gs that carry cruise missiles in the mid-to-late 1990s, as the ATB is fielded. This option would retire these aircraft by 1988 as the B-1Bs are fielded. Operating and support savings would equal $270 million in 1987 and $4.8 billion over the next five years. These savings include funds that would have been used to modify these aircraft. Although the bomber force would be somewhat smaller than its current size for a few years, numbers would rise somewhat above current levels as the ATB is deployed.

There would be other advantages as well. The SALT II treaty limits to 1,320 the numbers of multiple warhead missiles and bombers carrying air-launched cruise missiles (ALCM); there is a further sublimit of 1,200 on multiple warhead missiles. As long as the United States continues to observe SALT II limits and maintains its other forces as planned, having more than 120 bombers carrying ALCMs would require compensatory reductions in multiple warhead missiles. If older B-52Gs were retired early, all B-52Hs and some B-1s could be modified to carry cruise missiles without triggering reductions in land- or sea-based missiles that would otherwise be mandated. Moreover, retiring these B-52G aircraft early would also reduce demand for tankers for aerial refueling, thus easing the shortfall for that aircraft.

DEF-21 ALTER OPERATION AND MAINTENANCE FUNDING

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Reduce 1987 Funding Request by 10 Percent						
Budget Authority	8,600	9,200	10,000	10,700	11,200	49,700
Outlays	6,700	8,700	9,600	10,300	10,800	46,100
Limit Funding Growth in Each of the Next Five Years						
Budget Authority	11,500	14,000	17,500	21,200	21,600	85,800
Outlays	9,000	12,900	16,300	19,900	20,900	79,000

About 27 percent of 1986 defense appropriations supports the operation and maintenance (O&M) of existing plant and equipment. Part of this account pays for civilian workers. The rest purchases goods and services for maintenance of existing equipment, training, fuel and spare parts, base operations, and many other things. Spending for these activities is commonly referred to as "readiness" spending since it contributes directly to the day-to-day capability of the military forces.

Since 1981, O&M budget authority has increased about 18 percent in real terms. Although some of this growth was needed to support an increase in the Navy and Air Force, much of it, according to DoD, was used to increase the readiness and training of forces that already existed. Current plans call for O&M budget authority to increase over 26 percent in real terms during the next five years. While detailed data are not available, growth is probably higher for O&M purchases than for costs of civilian personnel. Presumably this higher funding stems from the cost of operating increased numbers of forces and of placing current forces at an even higher state of combat readiness and effectiveness.

The planned additions to military forces during this period, however, do not seem to require substantial increases in O&M. Based on five-year force structure and modernization plans submitted by DoD in February 1985, CBO projects an increase in tactical aircraft of 16 percent in the Air Force and 12 percent in the Navy. Numbers of strategic aircraft will remain relatively constant. Navy battle force ships will increase by 12 percent while total Army divisions remain unchanged. CBO estimates that these overall changes will require about 3 percent real increase in O&M spending over the next five years, if the present spending patterns are maintained. Furthermore, current forces are at a very high level of readiness according to DoD.

Reduce 1987 Funding Request by 10 Percent. Beyond the 0.3 percent in 1987 needed for new forces, increases in O&M would presumably be spent for activities to improve current readiness levels. If improvements to date in force readiness were deemed sufficient, growth in O&M could be slowed. In 1986, the Congress limited the budget authority for O&M to about the 1985 level in nominal terms. Sequestration as a result of the Balanced Budget Act, however, reduced this by another 4.9 percent. Reducing the O&M funding request by 10 percent in 1987--about the same percent reduction voted by the Congress in 1986--and then allowing it to increase at rates proposed by the Administration in subsequent years would save $8.6 billion in budget authority in 1987 and a total of $49.7 billion over the next five years. In 1987 this might require reducing operating tempos relative to today's level, unless operating and maintenance efficiencies could be realized. This reduction, however, would be offset by the increased real spending proposed in later years. CBO cannot specify in detail the effects of such a limit because of the large number of O&M projects, each of which could be affected differently.

Limit Funding in Each of the Next Five Years. Alternatively, the Congress could choose to hold O&M budget authority at the 1986 level in nominal terms for one year, followed by zero real growth in subsequent years. This would save $11.5 billion in budget authority in 1987 and $85.8 billion over the next five years. As with the previous approach, operating tempos might have to be reduced in 1987. But, unlike the previous approach that allowed real increases in O&M beyond 1987, the services would probably not be able to return to the 1986 operating levels unless other changes were made--such as a transfer of more forces to the Reserves (see, for example, DEF-19). Furthermore, under this approach, the services would not have increased funds to operate new forces unless they further reduced the operating tempos of existing forces. Thus, adopting this alternative might force the services to choose between maintaining readiness and force expansion in subsequent years.

DEF-22 RESTORE FORMER ENLISTED-OFFICER RATIOS

Savings from Admin. Request	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
	Savings in Total Federal Budget a/					
Budget Authority	102	372	714	954	1,035	3,177
Outlays	70	259	504	682	747	2,262
	Savings in Defense Budget a/					
Budget Authority	106	388	745	988	1,075	3,302
Outlays	103	380	734	981	1,072	3,270

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

The ratio of enlisted personnel to officers in the Armed Forces could be increased, possibly with little loss of military effectiveness. Since its post-Vietnam peak in 1977, the ratio has declined from 6.5 enlisted personnel for every officer to about 6.0 per officer in 1985. (Between 1964 and 1985, the ratio decreased from 6.8 to 6.0.) The sharpest drop has occurred in the Army; its ratio has fallen from 7.0 enlisted personnel per officer in 1977 to 6.2 in 1985. The Department of Defense manpower projections imply that, without active policy changes, the overall ratio will remain constant at its new level through 1989.

This declining ratio does not appear to reflect changing military requirements. Some military missions, such as training, require fewer enlisted personnel per officer than other missions (general purpose combat forces, for example). But the decline in the overall ratio is not explained by shifts in major military missions. Nor does it appear that increases in the technical complexity of weapons systems justify having more officers relative to enlisted personnel. And there is no evidence that the declining ratio is a response to overall budgetary trends or pay levels. Instead, the ratio has fallen steadily for the past nine years, during which time both military pay and total defense spending have first fallen and then risen in comparison with civilian pay and the overall level of GNP.

In principle, each of the services plans the mix of officers and enlisted personnel at a highly detailed level and then aggregates its plans to yield overall personnel totals. Apart from equipment modernization, this process might produce a declining enlisted-officer ratio as the result of such considerations as maintenance of a larger mobilization cadre or substitution of senior enlisted and officer supervisory personnel for junior enlisted forces. In the absence of specific explanations for the falling enlisted-officer ratio, however, the persistent tendency of the ratio to decline might indict a need to impose aggregate limits. Such limits would also be consistent with Administration efforts to reduce the number of federal civilian personnel at middle and senior levels.

To meet such overall constraints while reexamining requirements for officers, the services could recruit fewer officers, leaving their enlisted recruiting plans untouched. If, over the next three years, the numbers of officers were reduced by 17,000, then by 1989 the ratio would be about 6.25 enlisted personnel per officer. This action would reverse about half the decline in the enlisted-officer ratio that occurred between 1977 and 1985. Such a policy would reduce manpower levels modestly in 1987. It would save $106 million in defense budget authority in 1987 and a total of $3.3 billion over the next five years, compared with the Administration's plans. In addition, such a limit might result in slower promotions within officer ranks and thus generate modest additional savings in pay and allowances beyond those estimated here.

Savings would be considerably smaller, of course, if the total numbers of military personnel were maintained at planned levels. In that event, the ratio of enlisted to officer personnel could be reduced by substituting enlisted personnel or lower-ranking warrant officers for commissioned officers.

DEF-23 IMPOSE FEES FOR MILITARY OUTPATIENT CARE

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	95	100	110	120	130	555
Outlays	75	95	104	115	125	515

Beneficiaries of the military medical care system pay nothing for their visits to military physicians. This option would charge those outpatients who are not on active duty (dependents of active-duty personnel and retired military personnel and their dependents) for each visit. Charges would be linked to ability to pay; enlisted families would pay $5 a visit, officers' families, $10. Total charges would be limited to $100 a year for each enlisted family member and $200 for each officer family member. These charges would increase yearly at the same rate as the daily charge for inpatient medical care, which dependents already must pay. Charging outpatients would help DoD defray the $58 it spends on average for each outpatient visit and would save at least $95 million in budget authority in 1987 and $555 million over the next five years. Administrative costs, which would offset part of this revenue, are reflected in the annual savings above.

Besides raising revenue, charging fees could also cut back on non-active duty outpatient visits. People overuse free medical services, thus contributing to overcrowding in military clinics. To get timely care, many beneficiaries turn to the more costly Civilian Health and Medical Program of the Uniformed Services (CHAMPUS). DoD could benefit from reduced overcrowding by attracting back to military facilities many outpatients who now use CHAMPUS; less recourse to CHAMPUS could save another $625 million through 1991. (These savings are not included above because they are less certain.) Or DoD could benefit from reduced overcrowding by channeling newly freed resources into other areas.

Because medical care is an important part of military compensation, military families would view outpatient charges as an erosion of benefits. Recruitment and especially retention could suffer, although the parallel trend in civilian medicine toward patients bearing a larger share of their medical costs might limit military dissatisfaction. Moreover, the small annual maximum charges should help to mitigate any adverse effects. Nor should a fee significantly harm health, a concern of some, since evidence shows that people at ages and income levels typical of military beneficiaries seek necessary medical care even when they share the costs.

DEF-24 SELECTIVELY RAISE MILITARY PAY

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	2,300	2,375	2,455	2,545	2,630	12,305
Outlays	1,570	1,625	1,665	1,705	1,745	8,310
Savings in Defense Budget a/						
Budget Authority	2,360	2,435	2,520	2,615	2,705	12,635
Outlays	2,325	2,435	2,520	2,610	2,705	12,595

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

Under current law, military personnel will receive an annual pay raise in October 1986. The Administration proposes a 4 percent increase, which should keep pace with wage increases in the private sector. But since everybody in active-duty and reserve service receives the same treatment, this across-the-board approach diffuses the incentives of pay raises. Selectively raising the pay of active-duty personnel--through higher special reenlistment bonuses--could meet many military needs at less cost. For example, substituting the selective increase described below for the proposed 4 percent raise would save $2.3 billion in budget authority from the Administration's request in 1987 and $12.3 billion over the next five years. (Annual raises after 1987 are assumed to keep pace with those in the private sector, but contain no adjustment to recoup the loss of an across-the-board raise in 1987.)

The services can most strongly influence retention in their enlisted career forces (personnel with more than four years of active-duty military service) by directing pay increases to the first and second reenlistment points, which usually occur in the fourth through tenth years of service. Before the fourth year, personnel are serving in their first term and pay does little to affect retention. After the tenth year of service, rates of reenlistment rise markedly because of the opportunity to retire at 20 years; moderate pay changes would affect those rates only marginally.

The services already pay selective reenlistment bonuses of up to $30,000 (though usually much less) to service members with critically needed skills who reenlist for at least three years during the fourth to tenth years. These bonuses are currently projected to cost $568 million in 1986. To produce about the same effect on the first- and second-term reenlistments as raising pay 4 percent across the board, spending on bonuses would have to increase about $225 million in 1987. Since eliminating the raise would save $1.8 billion, net savings over the Administration's request would amount to $1.6 billion.

One drawback to this option is that it would erode some of the recruiting success of recent years, because recruits and junior personnel would receive no raise in pay in 1987. Nonetheless, recruitment should remain well above historical levels, at least through 1988.

In addition, those personnel not receiving a selective pay raise might well feel unfairly treated. The more senior among them could become upset about "pay compression" since senior personnel might not enjoy as great an advantage in pay as the people under their supervision. Although service members unhappy about the fairness of their pay might not depart in large numbers, they could lose motivation and become less productive. Officers also would not receive any additional selective pay under this approach. Although their recruitment and retention has been good in recent years, officers could be adversely affected. Still, officer losses are not likely to be severe under this option.

These drawbacks suggest that substitution of a selective pay raise for an across-the-board increase should be used sparingly, mainly as a way to hold down costs. This option proposes such a substitution just for 1987, with across-the-board increases returning in later years. Indeed, in the long run, annual military pay raises will have to keep pace with increases in private-sector pay if the services are to avoid losing their best people.

DEF-25 IMPLEMENT PROPOSED CHANGES IN MILITARY RETIREMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	134	411	704	993	1,243	3,485
Outlays	0	-1	-5	-16	-27	-49
Savings in Defense Budget a/						
Budget Authority	134	411	704	993	1,243	3,485
Outlays	134	411	704	993	1,243	3,485

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

In 1987 the military retirement system will provide benefits for about 1.4 million people at a cost of over $18 billion. Changes to reduce the cost of this system and to improve its incentives for efficient management of military personnel have been recommended by at least nine major studies since 1969. In the 1986 DoD Authorization Act, the Congress took a major step toward implementing those recommendations by mandating a reduction of $2.9 billion--16 percent--in the annual accrual cost of military retirement (using the cost methodology in effect for fiscal year 1986) and by directing the Department of Defense to propose structural changes in the system to yield those savings. In November 1985, DoD responded by offering two alternative proposals consistent with the Congressional mandate, although it does not recommend any change in military retirement and has not assumed any savings in its budget for the 1987-1991 period. Those proposals are now awaiting Congressional action.

This option illustrates the savings that would result from enactment of one of the DoD proposals, called the "Combination Plan." Changes to the military retirement system, which would apply only to members entering service after enactment of the new plan, would include reductions in the basic annuities of military retirees. For example, the annuity of a retiree who left service after 20 years would be 44 percent of the retiree's "high-three" average basic pay, rather than 50 percent as under the current system. In addition, the DoD proposal would diminish inflation protection for retirees. Instead of the full cost-of-living adjustments (COLAs) provided under the current system, retirees would receive COLAs of one percentage point less than the change in the Consumer Price Index (CPI). At the fortieth anniversary of entry into service, however, retirees' annuities would be recomputed to the level they would have reached under full COLAs, following which future COLAs would continue at one percentage point below the CPI. The purpose of this one-time restoral is to protect, at least partially, the value of retirement pay during old age.

Enacting the Combination Plan would save an estimated $134 million in budget authority and outlays in the defense budget in 1987 and $3.5 billion from 1987 through 1991, but as explained below, it would add $50 million in total federal outlays through 1991. (The difference between defense and federal outlays is the result of accrual accounting for military retirement. Accrual savings in 1987 are much lower than the 1986 target of $2.9 billion because of changes in the costing methodology adopted by the DoD Board of Actuaries.) All savings are relative to the Administration's proposed budget and assume that the Combination Plan would be enacted during 1986 and applied only to personnel entering military service in fiscal year 1987 or later.

Although DoD presented the Combination Plan as one way of complying with the Congressional mandate, the department does not advocate it. DoD contends that any reduction in future retirement benefits would induce premature retirements and so reduce the size of the military career force (defined to include those with four or more years of service). CBO estimates that the proposed changes would eventually leave the career force about 3 percent smaller than it would be under continuation of the current retirement system. But the change should just slow future growth rather than reduce it below today's level. If necessary, even this slowed growth could be offset by increases in other incentives, such as reenlistment bonuses for service members in those skills in which retention of experienced people is most needed. This possible cost increase was not included in the above table, but it would not offset more than a small part of the total savings.

CBO's estimates of the savings from the Combination Plan reflect the accrual accounting procedures that were first implemented in the budget for fiscal year 1985. Under these procedures, the accrual costs of future retirement liabilities, rather than actual current payments to retirees, appear as budget authority and outlays in the defense budget and budget authority in the total federal budget. Accrual accounting is designed to show the costs of future retirement in today's defense budget, so that retirement costs will be considered in decisions made today, even though the actual expenditures will not occur for many years. Actual payments to retirees still determine federal outlays, however.

For the 1985 and 1986 budgets, DoD calculated the accrual charges for military retirement by projecting the cost for an entering group of new service members (referred to as their "Entry-age Normal Cost"). Under this procedure, savings from the Combination Plan would have been calculated as $2.9 billion, the amount mandated by the Congress. In effect, this procedure ignored the fact that most personnel now in service would have continued to be covered under the current military retirement system rather than under the Combination Plan.

Beginning with the 1987 budget, however, DoD's Board of Actuaries decided to calculate the accrual charge for military retirement based on the weighted average normal costs for all personnel currently in service. CBO's estimates in the above table incorporate this methodological change. Assuming that the Combination Plan was enacted in 1986 and applied to all members entering the service in 1987 or later, only first-year personnel would be covered by the new plan during fiscal year 1987. For these people, the savings in retirement accrual charges would be 16 percent. For all other personnel, however, there would be no savings. The first-year (1987) reduction in DoD budget authority, therefore, would be only a small fraction of the $2.9 billion savings that would be realized once all service members were covered by the Combination Plan. In 1988 first- and second-year members would be covered by the Combination Plan, so--as shown in the table--accrual savings would be roughly twice as great as in 1987. Further increases in annual savings would arise as the new plan applied to larger numbers of service members.

Over the five-year period, the Combination Plan would cause a large reduction in defense and total budget authority and defense outlays. These reductions in budget authority correspond to the savings in retirement outlays that the government eventually would realize under the Combination Plan. Under accrual accounting, however, DoD outlays for the accrual costs are cancelled out elsewhere in the federal budget, so federal outlays continue to reflect actual payments to retirees. These payments would begin to fall only after members covered by the Combination Plan reached retirement.

Estimated outlays in the federal budget would also be affected by changes in the overall composition of the military forces. As noted above, the Combination Plan would eventually lead to a smaller military career force and, thus, to associated changes in personnel costs. Military pay and allowances would fall somewhat with the change to a slightly more junior force, but these reductions would be more than offset initially by higher costs of training and recruiting. CBO's estimates assume that these changes in associated personnel costs would phase in over the first five years after enactment of the Combination Plan. Under this assumption, the net five-year increase in federal outlays would be $50 million.

ENTITLEMENTS AND OTHER MANDATORY SPENDING

This category presents 24 options that would either reduce outlays for entitlements and other mandatory spending or increase general and earmarked revenues. ENT-01 through ENT-11 deal with health care programs. ENT-12 through ENT-18 discuss alternatives for reducing net federal outlays for Social Security and other retirement and disability programs. ENT-19 through ENT-24 deal with other entitlements, including means-tested and non-means-tested benefits and grants to state and local governments.

Several of the options are substitutes for one another. For example, ENT-07 through ENT-09 represent three alternative ways of increasing beneficiaries' contributions to Medicare, with contrasting effects on beneficiaries at different income levels. Also--as in ENT-03 and ENT-12, for instance--the individual summaries describe more than one specific policy alternative. The savings for the separate options--or from the variants within a single option--should not be added together to arrive at a total because, in general, they could not be combined.

ENT-01 TAX EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Tax Some Employer-Paid Health Insurance						
Income Tax	2.5	4.2	5.2	6.4	7.7	26.0
Payroll Tax	1.0	1.7	2.1	2.5	3.0	10.3
Total	3.5	5.9	7.3	8.9	10.7	36.3
Tax Employer-Paid Health Insurance But Allow a Credit for Employer and Employee Contributions						
Income Tax a/	-0.1	0.7	1.1	1.5	1.8	5.0
Payroll Tax	7.1	10.1	11.3	12.5	13.8	54.8
Total	7.0	10.8	12.4	14.0	15.6	59.8

a. Negative revenues represent the net effect of additional revenues from counting employer-paid health insurance as part of taxable income and reduced tax payments from credits for employer and employee contributions.

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce 1987 income tax revenues by approximately $26 billion and Social Security payroll tax revenues by an additional $9.5 billion. Moreover, the recent onset of "cafeteria plans" and "flexible spending accounts" (FSAs) raises the amount of health insurance payments escaping taxation (see REV-21).

Tax Some Employer-Paid Health Insurance. One proposal to limit the exclusion would be to treat as taxable income any employer contributions (including those in cafeteria plans and FSAs) that exceed $200 a month for family coverage and $80 a month for individual coverage (in 1987 dollars), with these amounts indexed to reflect future increases in the general level of prices. This proposal would raise income tax revenues by $26 billion and payroll tax revenues by $10.3 billion over the 1987-1991 period. Including employer-paid health care coverage in the Social Security wage base, however, would lead to increased outlays on benefit payments that would offset most of the added payroll tax revenues from this option over the long run.

Proponents of this approach point out that it would eliminate the tax incentive to purchase additional coverage beyond the ceiling, which reduces incentives to economize in the medical marketplace and increases the upward pressure on medical care prices. Over the long run, indexing the limits would prevent their erosion by inflation. Finally, they note that the Congress has already limited the exclusion for employer-paid group life insurance (see REV-21).

Opponents object to limiting the tax subsidy, pointing to the difficulty of determining just when extensive coverage becomes excessive. They further argue that a uniform ceiling would have uneven effects, since a given employer's contribution purchases different levels of coverage depending on such factors as geographic location and the demographic characteristics of the firm's workforce. Finally, the indexing provision of this proposal would lead to declining subsidies for employer-paid health insurance in the long run, if health insurance costs continue to rise faster than the general level of prices. This is of concern to people who argue that these subsidies to private-sector benefits help avoid the need for public provision of the same benefits.

Tax Employer-Paid Health Insurance But Allow a Credit for Employer and Employee Contributions. Another option would be to treat all employer-paid health insurance premiums as taxable but offer a tax credit of 25 percent for health insurance premiums up to the amounts described above for family and individual coverage. The credits would be available to taxpayers regardless of whether the coverage was paid for or sponsored by an employer. At this credit percentage and with these premium ceilings, the proposal would increase income tax revenues by $5 billion and payroll tax revenues by $54.8 billion over the 1987-1991 period. As under the first option, increases in Social Security outlays would offset most of the added payroll tax revenues in the long run.

Proponents of this approach argue that, in addition to eliminating the tax incentive to purchase health insurance above the limits, the subsidy would be made available to taxpayers without regard to their employment status. Moreover, the subsidy per dollar of eligible health insurance coverage purchased would not vary with taxpayers' incomes. Others, however, object that the benefits of a tax credit would not be available to low-income individuals and families who have no liability under the federal personal income tax. Although benefits of the credit could be extended to these people by making it refundable, doing so would substantially reduce the net revenues discussed above.

As with the first option, some opponents argue that current health insurance coverage is not excessive. Opponents of the tax credit argue that the tax system should not be used to encourage purchases of certain goods or services and that extending the credit to those who currently have no employer-paid health insurance would further this tendency.

The Administration's tax reform proposal would include in taxable income the first $10 per month (for single coverage) or $60 per month (for family coverage); H.R. 3838 would retain the current law exclusion for health insurance benefits.

ENT-02 REDUCE MEDICARE'S PAYMENTS FOR INDIRECT MEDICAL EDUCATION COSTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Outlays	780	1,000	1,100	1,250	1,350	5,480

Medicare's prospective payment system (PPS) includes higher payment rates to cover the additional costs of patient care (that is, costs of treating each Medicare patient) incurred by hospitals with teaching programs. These costs are known as indirect medical education costs. The federal portion of payments for hospitals with approved medical education programs are raised by 11.59 percent for each 0.1 percentage point of the hospital's ratio of full-time equivalent interns and residents to its number of beds (IRB). This addition is double the adjustment estimated at the onset of PPS by the Health Care Financing Administration (HCFA) as necessary to compensate for indirect medical education costs. The Congress doubled the adjustment as an interim step to cover higher costs caused by a variety of factors that were not otherwise accounted for in setting PPS rates. These factors include severity of illness (within diagnosis-related groups), inner-city location, and a disproportionately large share of low-income patients--all of which are associated with large teaching programs.

Further analysis of the indirect teaching adjustment by CBO, using a statistical method that allowed the adjustment to reflect all factors not now considered in setting PPS rates, found the adjustment factor to be 8.7 percent--about 25 percent lower than the current adjustment of 11.59 percent. Moreover, the analysis demonstrated that indirect costs of medical education increase at a slower rate as teaching programs get larger. Therefore, the current method of making equal incremental payments for each 0.1 percentage-point increase in the IRB (a linear basis) tends to overcompensate hospitals with the largest teaching programs. If the current adjustment were reduced to 8.7 percent and restructured in a manner consistent with CBO's analysis to pay smaller increments as the teaching programs get larger (a curvilinear basis), indirect teaching payments would be reduced by $5.5 billion over fiscal years 1987-1991.

Although this proposal would reduce total revenues for hospitals, it would better align their PPS payments with the patterns of costs the system was designed to recognize. Problems of equity would continue to arise, however, using the indirect medical adjustment to pay for factors other than teaching costs. For example, all teaching hospitals would receive these payments, although many are not located in inner cities or do not serve a disproportionately large share of low-income patients. Moreover, a number of nonteaching hospitals have these characteristics, but would continue to receive no additional payments.

The Administration has proposed that the indirect teaching adjustment be reduced to 5.795 percent and be paid on a curvilinear basis. This proposal would save approximately $9.8 billion over fiscal years 1987-1991, but would no longer compensate teaching hospitals for costs associated with severity of illness and scope of facilities.

ENT-03 REDUCE REIMBURSEMENTS FOR CAPITAL EXPENDITURES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Move Immediately to a Prospective Reimbursement System						
Outlays	220	450	700	960	1,270	3,600
Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	490	790	1,120	1,420	1,780	5,600
Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	20	100	370	800	1,310	2,600

Although the Social Security Amendments of 1983 set up a prospective payment system (PPS) to reimburse hospitals for operating costs associated with treating Medicare beneficiaries in various diagnosis-related groups (DRGs), they did not change the retrospective, cost-based method of reimbursing capital-related expenses such as interest, rent, and depreciation. Reimbursements for capital expenses account for about 9 percent of Medicare payments to hospitals--roughly $4 billion in fiscal year 1986.

All three of the approaches discussed here would lead to prospective payment of capital. The first two would do so immediately, while the third would partially retain cost-based reimbursement during a five-year transition to a fully prospective system. In addition, two of the approaches would redefine the capital expenses that would be eligible for reimbursement under the prospective system.

Move Immediately to a Prospective Reimbursement System. The current cost-based method of reimbursement for capital-related expenses could be replaced immediately by a prospective system under which capital expenses would be reimbursed by increasing all the DRG rates by the same fixed percentage. If this percentage add-on were set at the ratio of capital costs to operating costs in 1986, Medicare's outlays would be reduced by $3.6 billion during the fiscal year 1987-1991 period. These savings would accrue because the DRG payments are projected to grow more slowly than actual capital costs.

Reimbursing capital expenses through the DRG rates would have several advantages. First, hospitals would have incentives to reduce capital costs as well as operating costs--for example, by seeking to delay projects when interest rates were high, whereas now that is not advantageous because all interest costs are reimbursed. In addition, this approach would avoid the current incentive to substitute capital for labor--the incentive that comes from combining prospective reimbursement for operating costs with cost reimbursement for capital expenses--even when that would raise the hospital's total costs. Finally, capital payments by Medicare would be predictable and controllable--for example, these outlays would not be increased if a hospital building boom occurred in the coming years.

The major drawback to this approach stems from the fact that individual hospitals' capital expenditures tend to be large and to occur infrequently, so some hospitals have capital expenses that are much higher than average in some years and much lower in other years. In other words, a percentage add-on based on the ratio of national capital costs to national operating costs in a base year would generally not match any particular hospital's current expenses.

A partial solution would be to have a transition period during which part of the prospective payment would be based on the national percentage add-on described above and part would be based on the particular hospital's capital-to-operating cost ratio in the base year. This modification--which is similar to the transition used under the PPS system for operating costs--would still move to a prospective system immediately and would not affect the total savings. The distribution of payments among hospitals during the transition period would differ, however. Hospitals that have recently undertaken large capital obligations would gain, relative to using only a national percentage add-on, while hospitals that currently have below-average capital expenses but need to modernize in the near future would be disadvantaged.

Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses. In addition to paying for capital prospectively, as in the previous option, the definition of capital expenses used to calculate the percentage add-on could be changed in two ways. First, Medicare could exclude the proportion of capital costs related to return-on-equity (ROE), which is currently an allowable cost only for proprietary hospitals. Proponents argue that the federal government ought to reimburse all hospitals in the same way--whether they are voluntary or proprietary. Moreover, because proprietary hospitals receive only about 10 percent of Medicare's payments, they point out that including ROE in the base for calculating the percentage add-on would spread these payments across all hospitals, effectively generating windfall gains for the voluntary ones. But others contend exactly the opposite--that ROE is a legitimate cost of doing business and either should continue to be reimbursed based on actual costs or should be paid prospectively under a separate add-on that would apply only to proprietary hospitals.

A second definitional change would reduce the amount of interest expenses used to calculate the fixed percentage add-on by the amount of interest hospitals earn on funded depreciation. Advocates of this offset point out that hospitals have invested their funded depreciation to generate income rather than using it to reduce the level of their outstanding debt, and they argue that the federal government should not reward hospitals for the resulting increase in their interest expenses. Opponents contend, on the other hand, that the prospective payments for operating costs are already low and that further cuts in federal payments would add to the financial stress some hospitals are experiencing from the PPS.

This option would lower Medicare's outlays by $5.6 billion during the 1987-1991 period. These savings would accrue both because the redefinition would lower the 1986 base amount of capital expenses by $320 million, and because under the prospective system for capital--which shares the advantages and disadvantages discussed in the previous option--payments are projected to grow more slowly than actual capital costs.

Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses. Another approach would be to move gradually from the current cost-based system to a prospective one in which capital expenses were redefined. For example, if during a five-year transition, 95 percent, 80 percent, 60 percent, 40 percent, and 20 percent, respectively, of the reimbursement were based on capital costs as now defined, with the remainder based on the prospective system described in the second option, cumulative savings for fiscal years 1987-1991 would be $2.6 billion.

Advocates of this approach argue that continuing partial cost-based reimbursement during a transition period would lessen financial stress for two large groups of hospitals--those with current high capital costs and those planning large capital investments during the transition period--and would reduce windfall gains for many others whose actual costs would be below Medicare's payments under the prospective system. Opponents counter that this approach would substantially reduce budgetary savings compared with immediate implementation of the prospective system and that the positive incentives of paying prospectively would be delayed.

The Administration's budgetary proposal contains aspects of the approaches detailed above. It would redefine allowable capital expenses over a three-year period and, over four years, would move to paying for capital expenses through a fixed percentage add-on to the DRG rates. During the transition, the hospital-specific portion would not necessarily be set prospectively; instead, it would be the lower of the hospital's actual capital costs or its 1986 costs increased by the growth in a typical hospital's capital costs since then.

ENT-04 REDUCE MEDICARE'S PAYMENTS TO HOSPITALS FOR DIRECT MEDICAL EDUCATION EXPENSES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Outlays	100	190	270	350	440	1,350

Medicare's prospective payment system does not include payments to hospitals for their direct costs of graduate medical education (GME)--that is, residents' and teachers' salaries, administrative costs, and classroom expenses. Instead, these costs are reimbursed separately and retrospectively, based on the proportion of total inpatient days attributable to Medicare beneficiaries. Last year, through regulation, the Administration imposed a one-year freeze on these payments by establishing a ceiling on the total reasonable costs of GME for each hospital. The Congress could continue to freeze GME payments from 1987 through 1991, but on a per-resident basis in order to allow hospitals flexibility to vary the sizes of their programs. The five-year savings would be about $1.3 billion. (This option would not change the treatment of training programs for nursing and allied health professions.)

Several arguments support limiting Medicare's payments for GME, which are currently nearly one-third of institutions' total GME costs. For example, such reductions would parallel the recent treatment of other federal programs that subsidize medical education, which have been cut back because of an expected surplus of physicians and because of budgetary constraints. In addition, by reimbursing whatever reasonable costs are incurred the current system encourages growth in the direct costs of residency programs; freezing payments on a per-resident basis would lower--and might even reverse--this incentive.

A long-term freeze on the GME passthrough would have several drawbacks, however. First, a per-resident GME funding freeze might adversely affect the quality of training provided by hospitals. Second, a per-resident freeze would not address concerns about the oversupply of some medical specialists and the undersupply of others. Third, fewer patient care dollars for low revenue-producing residency programs--such as family practice--might make some of these programs financially unviable. Fourth, because hospitals' cost accounting practices vary in the share of actual GME costs currently reported, a freeze would prevent improvements in cost accounting from being reflected in more accurate payments. Finally, an extended freeze might eventually leave payment rates below the costs of patient care that is now provided by residents. In this instance, other payers might be forced to subsidize care for Medicare patients or the quality of those patients' care might deteriorate, because other Medicare payments to hospitals do not cover these costs.

Several alternatives to a freeze would address some of these drawbacks. For example, to respond to concerns about oversupply of various specialties, the Congress might limit GME reimbursements to the costs of residents in particular specialties or in the early years of their training programs. Programs not reimbursed under this approach, however, might be unable to find alternative sources of funding and might be forced to close. Another alternative would be to calculate the per-resident payments for groups of hospitals, thereby reducing the effect of individual accounting practices on payment levels. Such an approach, however, would not recognize the actual cost of the programs to the hospitals, so some programs would be reimbursed for less than their costs and others would receive more.

The Administration's 1987 budget would eliminate Medicare payments for the education- and classroom-related costs of residency programs. In addition, hospital-specific limits on payments for residents' services would be set.

ENT-05 INCREASE THE HOSPITAL INSURANCE PAYROLL TAX

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	7.4	10.2	10.9	11.8	12.8	53.1

The Hospital Insurance (HI) component of Medicare, which accounts for almost 70 percent of total program outlays, is largely financed by a portion of the Social Security payroll tax. Employees covered by the HI program and their employers currently each contribute 1.45 percent of the first $42,000 of earnings. The taxable earnings ceiling rises automatically with average wages each year.

Increasing the HI payroll tax rate would reduce the federal budget deficit and help maintain the solvency of the HI trust fund. Although projections for the trust fund are uncertain, financial problems are ultimately likely to occur because HI outlays are projected to grow faster than income, in part because of the aging of the population. A 0.5 percentage-point increase in the combined tax rate for employers and employees beginning in 1987, for example, would generate $53 billion in revenues over the 1987-1991 period and postpone any future financing problems.

Some argue, however, that payroll taxes are already too high. Currently scheduled increases mean that the combined employer and employee Social Security tax rate--for retirement benefits, disability payments, and Medicare--will have increased by 3.6 percentage points between 1975 and 1990, from 11.7 percent to 15.3 percent. Moreover, Social Security payroll taxes already account for an increasing share of total federal revenues--rising from 26 percent in 1980 to about 34 percent in 1989. Further increases in the payroll tax could have adverse effects on employment and inflation, because the cost of hiring workers would rise. In addition, this option would increase both the relative and absolute tax burden of those with lower earnings, because the tax applies only to earnings below a specified limit.

The Administration did not propose any changes in the HI payroll tax.

ENT-06 ADOPT A FEE SCHEDULE FOR REIMBURSING PHYSICIANS UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Fee Schedule with Rates Updated Annually by the MEI						
Budget Authority	--	150	270	370	500	1,290
Outlays	--	130	250	340	460	1,180
Fee Schedule with Spending Cap Set by the MEI						
Budget Authority	--	720	1,500	2,440	3,590	8,250
Outlays	--	570	1,310	2,200	3,240	7,320
Fee Schedule with Spending Cap Set by Growth in GNP						
Budget Authority	--	160	300	480	760	1,700
Outlays	--	130	260	430	670	1,490

Medicare currently reimburses physicians under the Supplementary Medical Insurance (SMI) program for "reasonable" charges for all covered services. A reasonable charge for a given service is the lowest of the physician's actual charge, the physician's customary charge for that service, and the prevailing charge for that service in the local community. This is known as the customary, prevailing, and reasonable (CPR) system.

Because of the automatic and inflationary link between physicians' actual charges and Medicare's payment rates in the next year, the CPR system has been criticized for contributing unnecessarily to cost increases. To weaken this link, since 1973, the allowed rate of increase in prevailing fees has been limited to the rate of increase in an economywide index of office expenses and earnings--the Medicare Economic Index (MEI). Because not all physicians' customary fees are at the ceiling set by prevailing fees, however, the rate of increase in payment rates has exceeded increases in the MEI. (Based on CBO tabulations from the Part B Medicare Annual Data Provider file, about 55 percent of reasonable charges were at the ceiling in 1984.)

As an alternative to the CPR system, a Medicare fee schedule--with adjustment for local differences in costs--could perhaps be put in place by October 1, 1987. The fee schedule that would be effective for fiscal year 1988 could be set at the average amounts allowed for each service during the previous year, with annual increases in payment rates determined thereafter by the rate of increase in the MEI. Savings under this option would be $130 million for fiscal year 1988, and would total $1.2 billion over the five-year period 1987-1991. 1/

One problem with this option is that a fee schedule based on average allowed amounts would incorporate elements of the current fee structure that many people believe need to be corrected, such as excessive payments for certain procedures that are either ineffective or far less costly to perform now than when they were first introduced. The rate structure could be modified incrementally after it has been put in place, or changes in physician payment methods could be delayed for several years until a more appropriate fee structure was developed. (The Health Care Financing Administration has awarded a contract to develop a relative value scale that could serve as the basis for a fee schedule; completion is scheduled for mid-1988.)

Further, control of total costs in a fee-for-service payment system probably requires constraints on volume of services as well as on fees. Other countries have successfully contained increases in volume under such systems by using two mechanisms in combination: volume-related adjustments in payment rates to cap total spending for physicians' services, together with a systematic monitoring of the practice profiles of physicians to prevent individual ones from making above-average increases in their billings at the expense of other physicians. If increases in total approved charges per enrollee were capped by increases in the MEI--so that payment rates would be reduced to offset increases in volume per enrollee--savings under the fee schedule discussed above would increase to $570 million for 1988 and would total $7.3 billion over the five-year period.

Some increases in volume of services per enrollee might be desirable, however, to account for aging of the Medicare population and medical advances. Total charges per enrollee could be permitted to increase by the growth in costs plus an appropriate allowance for these factors, before triggering a downward adjustment in payment rates. The appropriate allowances for aging and technology could be difficult to determine, however. This is especially so for medical advances, which might either increase or reduce the variety and costs of services that could benefit enrollees.

---

1. See CBO, *Physician Reimbursement Under Medicare: Options for Change* (forthcoming).

One option would be to allow total charges per enrollee to increase each year according to growth in GNP. Consequently, some increase in the volume of services per enrollee would be permitted so long as payment rates increased less rapidly than GNP. Savings under this option would be $130 million for 1988 and $1.5 billion over the five-year projection period, but the allowed growth in volume could be greater or less than that warranted by aging and technological change.

Other approaches could reduce the undesirable incentives for volume by basing reimbursements on more comprehensive packages of services--such as all services provided during an episode of hospital inpatient care (similar to the prospective payment system for hospital reimbursement), or on all services required by enrollees during a specified period of time (capitation). Before either of these alternatives could become the dominant payment method for physicians' services under Medicare, however, a number of implementation and feasibility issues would need to be resolved. Implementation of a fee schedule now would not prevent more fundamental changes in payment methods later, when acceptable alternative approaches are developed.

The Administration has proposed to retain the CPR system for the time being, with some refinements, while taking steps to increase the number of Medicare enrollees receiving care on a capitated basis in the long term. The principal refinements to the CPR system the Administration plans include: making a technical correction to the MEI that would have the effect of reducing the increase in MEI-adjusted prevailing fees scheduled for October 1, 1986, from an estimated 3.2 percent to only 0.8 percent; reducing payment rates for selected services that seem to be overpriced; and encouraging carriers to reduce the number of locality and specialty differentials they recognize.

ENT-07 INCREASE MEDICARE'S PREMIUM FOR PHYSICIANS' SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	970	1,350	1,430	1,525	1,620	6,895
Outlays	970	1,350	1,430	1,525	1,620	6,895

Medicare's Supplementary Medical Insurance (SMI) program is partially funded by monthly premiums--currently $15.50--paid by enrollees. Between 1972 and 1982, premium receipts covered a declining share of SMI costs--dropping from 50 percent to 25 percent--because premiums were tied to the rate of growth in Social Security benefits, which is based on the Consumer Price Index, rather than on the faster-rising per capita cost of SMI. (The remaining costs are paid from general revenues.)

In 1982, premiums were set through 1985 (later extended through 1987) to cover 25 percent of the average benefits for an aged enrollee. Under current law, beginning in 1988 the premium calculation will again be limited to the rate of growth of Social Security benefits. If, instead, the premium were set so that participants would pay 30 percent of benefits beginning January 1, 1987, and for all years thereafter, federal savings would total $1.0 billion in fiscal year 1987 and $6.9 billion over the five-year period. The estimated premium would be $21.70 on January 1, 1987, instead of the scheduled $18.10.

Under this option, the increase in payments would be shared by all enrollees, in contrast to increased copayments that would affect only the users of medical services, who may be more financially pressed during their period of illness. Also, it would not affect the poorest enrollees because they are likely to be eligible for Medicaid, which usually pays the SMI premium on their behalf. For those not eligible for Medicaid, the higher premium would be less than 5 percent of the average monthly Social Security benefit in 1987, slightly more of a burden than in 1967--the first full year for Medicare--when the premium was 3.6 percent of the average Social Security benefit.

Low-income enrollees who are not eligible for Medicaid could find the increased premium burdensome, though. A few might drop SMI coverage and either do without care or turn to sources of free or reduced-cost care, which could increase demands on local governments.

In its 1987 budget, the Administration proposed to increase the SMI premium gradually over five years, until it would cover 35 percent of costs. This would save more over the five-year period, but less in the first two years, than the option discussed here.

ENT-08 USE THE TAX SYSTEM TO IMPOSE A SUPPLEMENTARY INCOME-RELATED PREMIUM FOR PHYSICIANS' SERVICES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.5	1.9	2.0	2.1	2.3	8.8

Part B of Medicare offers Supplementary Medical Insurance (SMI), which covers a portion of enrollees' physician and other nonhospital charges. Participation is voluntary, and enrollees currently pay a monthly premium of $15.50. The premium is adjusted annually to cover 25 percent of the average costs incurred by an elderly enrollee. The balance of costs, more than $20 billion for 1987, is paid from general revenues.

An alternative to increasing the share of costs financed by the current premium would be to impose a supplementary income-related premium. To avoid having to set up a new bureaucracy to collect these premiums from enrollees, this option could be most conveniently introduced through the income tax system.

A 1 percent tax, for example, could be imposed on enrollees' taxable income above the zero bracket amount. A ceiling on added tax liability for each tax filing unit (usually an elderly individual or couple) could be set by the number of SMI enrollees in the unit times the average value of subsidized SMI benefits per enrollee. In this way, no unit would pay more than the full actuarial value of its benefits. If an SMI tax of 1 percent were imposed on taxable income for all units with at least one SMI enrollee during the tax year (prorated for part-year enrollment), revenues earmarked for the SMI trust fund would be increased by $0.5 billion in 1987, and by $8.8 billion over the five-year period. 1/

In contrast to the premium discussed in ENT-07, this approach would fall less heavily on low-income enrollees and more heavily on those with

---

1. See CBO, *An Analysis of Selected Deficit Reduction Options Affecting the Elderly and Disabled* (March 1985).

high incomes. The poorest enrollees--those with no taxable income--would not be affected, whether or not they were eligible for Medicaid benefits. The amount paid would vary directly with the amount of taxable income. As a result, individuals with taxable income below $6,890 a year would pay less under this approach, while those with taxable income above $6,890 would pay more than if premiums were increased to cover 30 percent of costs. The effect on low- and moderate-income enrollees could be reduced still further by using personal income tax rates--as in ENT-09--rather than the proportional tax used in this option.

Some people might consider the tax inequitable because the amount of tax paid by each tax unit would not vary with the number of SMI enrollees in a unit, except for a small number of high-income tax units affected by the ceiling. In addition, some might question whether it was fair to require those with higher incomes to pay a relatively greater share of SMI costs when such people are typically less costly to the Medicare program because of their better health.

The Administration has made no proposal for an income-related SMI premium.

ENT-09 TAX A PORTION OF MEDICARE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
With Income Threshold	0.8	2.9	3.5	4.3	5.3	16.8
Without Income Threshold	1.5	5.1	6.0	7.0	8.2	27.8

Eligibility for Hospital Insurance (HI) benefits is based on working-year tax contributions, half of which are paid by employees from after-tax income and half by employers from pre-tax income. Eligibility for Supplementary Medical Insurance (SMI) depends on payment of a premium, which currently covers about 25 percent of SMI benefits. Hence, effective January 1, 1987, 50 percent of the insurance value of HI benefits and 75 percent of the insurance value of SMI benefits might be treated as taxable income for enrollees, with the resulting tax proceeds returned to the Medicare trust funds. This proposal is analogous to taxing part of Social Security benefits, which is already part of the law for beneficiaries for whom modified adjusted gross income plus half of Social Security benefits exceeds $25,000 (for individuals) or $32,000 (for couples).

If the current income thresholds for the tax on Social Security benefits were also used to limit the application of the tax on Medicare benefits--with the portion of Medicare benefits described above added to modified adjusted gross income plus half of Social Security benefits to compare with the threshold--then taxing both HI and SMI benefits would yield additional revenues of $0.8 billion in 1987 and $16.8 billion over the five-year period 1987-1991. If no income thresholds were used to limit the application of the Medicare tax, additional revenues would be $1.5 billion in 1987 and $27.8 billion over the five-year period. 1/

A tax on HI benefits would strengthen the HI trust fund. A tax on SMI benefits would shift some SMI costs from the general taxpayer to enrollees,

---

1. See CBO, *An Analysis of Selected Deficit Reduction Options Affecting the Elderly and Disabled* (March 1985).

without increasing costs for low-income enrollees and therefore not threatening their access to care. Moreover, if income thresholds were used, even middle-income enrollees would be protected from additional liability under this option. (Higher-income enrollees would pay more under this option than under ENT-08, but only because of the inclusion of HI as well as SMI costs. In contrast to ENT-08, people enrolled in the SMI program would never pay the full insurance value of their benefits under this option, since the maximum personal income tax rate to be applied to the subsidy value of benefits would be 50 percent under current law.) Further, since this option would use the mechanism already in place for taxing Social Security benefits, it would present no additional administrative difficulty.

Unlike the tax on Social Security benefits, though, this tax would be imposed on the insurance value of in-kind benefits rather than on dollar benefits actually received--a modification of current tax policy. (If the tax were imposed on actual benefits received, however, the Medicare tax would be directly related to enrollees' health care costs, reducing the insurance protection Medicare is intended to provide.) In addition, some people object to this option because enrollees could not alter their tax liability by choosing a different package of benefits, except by dropping SMI coverage altogether. Further, because of their better health, people with higher incomes are typically less costly to the Medicare program. Thus, requiring them to pay a greater share of the costs might be viewed as inequitable. Finally, the additional tax liability could be substantial--up to $800 per enrollee for 1987.

The Administration has made no proposal to tax Medicare benefits.

ENT-10 INCREASE MEDICARE'S DEDUCTIBLE FOR PHYSICIAN SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	720	1,130	1,340	1,535	1,695	6,420
Outlays	620	1,070	1,280	1,480	1,630	6,080

Appreciable federal savings in Medicare's Supplementary Medical Insurance (SMI) program could be realized by increasing the deductible--that is, the amount that enrollees must pay for services each year before the government shares responsibility. The deductible is now $75 a year. This deductible has been increased only twice since Medicare began in 1966, when it was set at $50. Hence, the deductible has fallen relative to average per capita benefits from 70 percent in 1967 to less than 10 percent for 1986. Increasing the SMI deductible to $200 on January 1, 1987, and indexing it thereafter to the rate of growth in the Consumer Price Index would save $620 million in fiscal year 1987 and $6.1 billion over the five-year period from 1987 through 1991.

Such an increase would spread the burden of reduced federal outlays among most enrollees, raising their out-of-pocket costs by no more than $125 each in 1987. Since a larger proportion of enrollees would not exceed the deductible (currently about 30 percent do not), it would both increase the number of enrollees with strong incentives for prudent consumption of medical care and reduce administrative costs to process claims.

On the other hand, even relatively small increases in out-of-pocket costs could prove burdensome to low-income enrollees who do not receive Medicaid, which pays deductible amounts for dual Medicaid-Medicare beneficiaries. That added expense might, in turn, discourage some people from seeking needed care.

In its 1987 budget, the Administration proposed to increase the SMI deductible to $100 for 1987, with increases in subsequent years based on increases in the Medicare Economic Index. This would save considerably less than the proposal discussed here.

ENT-11 LIMIT PAYMENTS FOR LONG-TERM CARE SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	750	870	990	1,100	1,250	4,960
Outlays	750	870	990	1,100	1,250	4,960

In recent years, growth in Medicaid spending for long-term care, including nursing home care and home health agency services, has outpaced growth in total Medicaid program outlays. Nursing home costs now comprise about 45 percent of Medicaid outlays. One way to contain increases in federal costs would be to restrict Medicaid's open-ended matching of funds for long-term care services. If increases in federal Medicaid payments for long-term care were limited to the inflation rate for medical care services, federal savings over the next five years would total almost $5 billion.

States would have to match the federal grant based on current Medicaid matching rates, and in the first year each state's allotment would be frozen at the 1986 amount. After 1987, federal grants would reflect adjustments relative to state population and other factors, such as the probable use of services in an area, the number of poor elderly and disabled people in the state, and a per capita payment for each type of service adjusted for the local costs of providing long-term care services. States would be allowed to determine their own provider and reimbursement policies under general federal guidelines.

Advocates of such a plan believe that it would encourage states to serve their long-term care patients more cost-effectively. Given more flexibility in the use of funds, states would probably substitute lower-cost home and community-based services for more costly institutional care, particularly for many mentally ill or mentally retarded patients. Furthermore, proponents say such a plan would force decisions to be made at the local level where services could be planned better and tailored to local conditions.

Opponents of this approach for long-term care fear that too much responsibility and financial burden would be shifted to the states. They believe that if federal funding is decreased, some needed services would not be provided because some states would not provide supplemental funding.

To provide adequate amounts and quality of care, states might increase local taxes or perhaps reduce some benefits to the "less-poor" beneficiaries. Others suggest that some states would respond to the plan by increasing the use of hospital services that would still be partially funded by the federal government under the current arrangements.

As an alternative, a comprehensive grant could be formed by combining all federal long-term care services into a single program. Although Medicare nursing home and home health services would not be included under this option, the new grant would replace funding for long-term care under the Social Services Block Grant (SSBG), Title III of the Older Americans Act, and Medicaid. This approach, however, would require estimating the amounts of SSBG and Title III funds used in this way. States would allocate resources from a single agency and would delegate to local agencies or contractors the necessary screening of and health care planning for patients.

Proponents of comprehensive grants believe this plan would reduce significantly the amount of fragmentation in current services that often produces gaps and overlaps in funding and could lower administrative costs. Critics suggest, however, that such a plan would lead to a reduction in services for the near-poor populations and might lead to a greater reliance on state-only funding than would result from capping Medicaid's payments for long-term care.

The Administration's budget would place a cap on all federal Medicaid spending for both acute care and long-term care in 1987 through 1991. In doing so, the proposal would include a special contingency fund of $300 million for states that might have unusual cost increases.

ENT-12 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	5,250	7,200	7,300	7,250	7,100	34,100
Other Non-Means-Tested Programs	1,350	1,850	1,900	1,950	2,000	9,050
Offsets in Means-Tested Programs	-880	-1,300	-1,350	-1,450	-1,500	-6,500
Total	5,700	7,750	7,800	7,800	7,600	36,700
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Social Security/ Railroad Retirement	1,700	4,750	8,250	11,900	15,550	42,150
Other Non-Means-Tested Programs	440	1,200	2,100	3,050	4,000	10,800
Offsets in Means-Tested Programs	-50	-200	-380	-560	-800	-2,000
Total	2,100	5,800	9,950	14,400	18,750	51,000
Limit COLAs to CPI Increase Minus Two Percentage Points for Five Years						
Social Security/ Railroad Retirement	3,100	7,450	12,050	16,850	21,850	61,300
Other Non-Means-Tested Programs	800	1,900	3,100	4,350	5,650	15,750
Offsets in Means-Tested Programs	-90	-320	-570	-820	-1,150	-2,950
Total	3,800	9,050	14,550	20,400	26,350	74,100
Pay Full COLA on Benefits Below a Certain Level and 50% of COLA on Amounts Exceeding That Level						
Social Security/ Railroad Retirement	590	1,650	2,800	3,950	5,150	14,150

Social Security and other non-means-tested cash transfer programs whose benefits are indexed to the Consumer Price Index (CPI) are expected to total $256 billion this year and to rise to $349 billion by 1991 under current policies. Reducing the automatic cost-of-living adjustment (COLA) for these programs is commonly proposed as an effective way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings resulting from each are shown in the table. 1/ Other options for achieving savings in Social Security are given in ENT-13 through ENT-17.

Advocates of COLA restrictions view them as a means of generating considerable savings while affecting most of the beneficiary population, in contrast to other budget options that would affect only relatively small groups of recipients. By limiting these options to the non-means-tested cash benefit programs, many of the poorest beneficiaries of entitlements--for example, recipients of Supplemental Security Income--would be protected from losses of income. Significant reductions in outlays would persist beyond the five-year projection period because the benefit levels of those eligible when the COLA limitation was implemented would be permanently lowered, although the savings would eventually disappear as beneficiaries died or ceased receiving payments for other reasons.

Opponents counter that budget reduction strategies that institute less than complete price indexing would result in financial difficulties for many recipients, particularly if they were applied for an extended period. Although the exclusion of means-tested benefit programs would limit the impact of COLA reductions for many low-income beneficiaries, many others would face substantial declines in their standards of living. COLA reductions also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement income policy. They argue that these programs should be altered only gradually and then only for programmatic reasons, because Social Security and other retirement programs represent long-term commitments both to current retirees and to today's workers. Thus, any changes in benefits should be announced well in advance to allow people to adjust their long-run plans.

If COLA limitations were adopted to restrict the growth in benefits for people after they retire, commensurate changes could be made in

---

1. The programs whose COLAs would be reduced under the first three options are: Social Security Old-Age, Survivors, and Disability Insurance (OASDI), Railroad Retirement, Civil Service Retirement, Military Retirement, Federal Employees Workers' Compensation, Veterans' Compensation, and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. The fourth option would affect only Social Security and Railroad Retirement Tier I COLAs.

determining initial benefits for new recipients to avoid introducing disparities in benefit levels among different groups of retirees. This situation is particularly relevant for Social Security, where benefits for those becoming eligible are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 4 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 5 percent, eliminating that year's COLA without any change in the calculation of initial benefits would result in benefits for new beneficiaries that were about 5 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To mitigate this problem and to achieve additional savings, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas determining initial benefits (see ENT-13 and ENT-14).

Several COLA options are examined below. The magnitude of the savings in each case--except the option to limit COLAs to two percentage points less than the CPI--is very sensitive to the assumed level of inflation in the years in which the COLAs would be reduced.

Eliminate COLAs for One Year. One option would be to eliminate COLAs in fiscal year 1987 for non-means-tested benefit programs, while allowing them to be paid in subsequent years but with no provision for making up the lost adjustment. If this approach were taken, federal outlays would be reduced by about $5.7 billion in 1987 and $36.7 billion over five years, with Social Security and Railroad Retirement accounting for most of the total. These estimated reductions would be larger or smaller if prices were to rise faster or slower than the 3.4 percent increase currently assumed for the fiscal year 1987 COLA.

Limit COLAs to Two-Thirds of CPI Increase. Under this option, recipients would be compensated for only a certain proportion of inflation, such as two-thirds of the annual CPI increase. Under current CBO economic assumptions, applying this restriction for five years would save about $2.1 billion next year and $51.0 billion over the 1987-1991 period. As a result, benefits for people who received payments throughout the five-year period would be about 7 percent less in 1991 than they would have been under full price-indexing. Both cumulative savings and reductions in real income would be greater in an environment of higher inflation and smaller under low inflation.

Index Benefits by the CPI Increase Minus Two Percentage Points. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points--for example, the CPI increase less two points. In this case, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about $74.1 billion over the next five years, if extended for the full period. (This option would reduce real incomes by about the same percentage every year, regardless of the inflation rate, whereas the two-thirds-of-COLA approach would reduce the purchasing power of benefits most sharply when inflation is high during the five-year period.)

Pay the Full COLA on the Portion of Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level. To ensure that lower-income beneficiaries would not be adversely affected by COLA reductions, some analysts have suggested tying the reduction to beneficiaries' incomes or payment levels. The example discussed here--based only on Social Security and Railroad Retirement Tier I benefits--would award the full COLA for benefits based on the first $400 of the retirees' Primary Insurance Amount (PIA) and 50 percent of the COLA on benefits above this level; the $400 threshold would also be indexed by the full COLA. This approach would save about $0.6 billion in 1987 and $14.1 billion over the 1987-1991 period. (Another option would be to provide the full COLA only to recipients whose benefits are based on a PIA below a certain level. Thus, the COLA reduction would affect the entire benefit of recipients above the threshold, not just the portion above that level.)

Several concerns, however, are raised regarding this approach. First, benefit levels are not always good indicators of total income. Some families with high benefits have very little other income, while some with low benefits have substantial income from other sources. On the other hand, targeting the COLA restraint on the basis of total income would be administratively complex. Indeed, implementation of the PIA-based option itself would involve considerable effort and would require a longer lead-time than the other COLA options because the Social Security Administration would need to rewrite many computer programs. (The budget savings estimates shown above nonetheless are based on implementation in time for the January 1987 COLA.) Second, if this proposal were extended to include other benefit programs, the different benefit structure in each program might require separate determinations of the appropriate benefit levels for paying the reduced COLA. Third, many people object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the "test" is limited only to the COLA.

The Administration's budget includes elimination of the January 1987 COLA for federal retirees, as well as other changes in the federal retirement system. No changes are proposed, however, in Social Security benefit rules.

ENT-13 LIMIT THE INCREASE IN THE SOCIAL SECURITY "BEND POINTS"

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Outlays	10	70	175	350	600	1,205

The Social Security benefit formula could be altered to reduce initial benefits for workers who become eligible in the future, thereby slowing the growth in outlays. Benefits of retired and disabled workers are based on a history of their earnings covered by Social Security, which is expressed as an average over most of their working lifetimes known as the Average Indexed Monthly Earnings (AIME). For people becoming eligible in 1986, the basic benefit or Primary Insurance Amount (PIA) is computed under the following formula: 90 percent of the first $297 of the worker's AIME, plus 32 percent of the next $1,493 of AIME, plus 15 percent of the AIME in excess of $1,790. Under current law, the formula's "bend points"--$297 and $1,790--are changed each year to reflect changes in average earnings in the economy.

If the rate of increase in the bend points were reduced by two percentage points annually in the 1987-1991 period, more earnings would fall into the brackets with lower replacement rates, causing benefits to grow more slowly. This approach would save about $1.2 billion from Social Security outlays over the 1987-1991 period, and more in later years. (Another way of limiting the increase in the bend points would be to index the annual changes to prices rather than wages. The effects of doing so would depend on the relative behavior of prices and wages.) Because the number of beneficiaries affected would grow, the savings that would result from reducing initial benefits--whether by changing the bend points or by the options described in ENT-14 or ENT-15--would be much larger in later years.

Under this option, the replacement rate--the ratio of benefits to preretirement earnings--for a 62-year-old retiree who has always earned the average wage would be about 33 percent in 1991 as compared with about 34 percent under current law. While the replacement rate under the option would still be higher than the rate for early retirees who first collected benefits in the late 1960s or early 1970s, it would be three percentage points lower than the 1979 peak in the replacement rates received by retirees aged 62 that year.

This option would increase Social Security trust fund reserves and reduce the government's borrowing requirements by gradually decreasing the proportion of preretirement earnings replaced by Social Security benefits. Proponents of this option point out that because of increased private pensions, tax-favored accounts, and real wage growth, new beneficiaries would probably have less need for benefits than would those currently receiving benefits. Moreover, under all but the most pessimistic economic assumptions, real benefits of successive retirement cohorts would continue to rise under this option, albeit at a slower rate than under current law. Coordinating this option with some of the cost-of-living adjustment options described in ENT-12 would ensure that the benefits of both current and future beneficiaries would be reduced to a similar extent.

If changes were made in the indexing of bend points, however, the effects on recipients of different benefit levels would vary. People with AIMEs at or slightly above the current law bend points would incur the largest losses in percentage terms, while those with slightly lower benefits would have smaller ones. Critics of the option also point out that replacement rates would continue to decrease for as long as the indexing was reduced. Further, even after full indexing was resumed, the incomes of affected beneficiaries would be permanently reduced. Finally, opponents argue that future benefits need not be reduced now. With the passage of the Social Security Amendments of 1983, the combined assets of the retirement and disability trust funds are expected to be sufficient to pay benefits for at least the next half century. Moreover, under current law, future cohorts of retirees will receive total benefits that are roughly equivalent to the amounts they will have paid in payroll taxes.

The Administration's budget does not contain any proposals for modifying the Social Security benefit structure.

ENT-14 REDUCE THE REPLACEMENT RATE WITHIN EACH BRACKET OF THE SOCIAL SECURITY BENEFIT FORMULA

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Outlays	65	260	480	750	1,100	2,655

Under current law, the basic Social Security benefit is determined by a progressive formula that provides workers with 90 percent of their Average Indexed Monthly Earnings (AIME) up to the first earnings bracket (called a bend point), plus 32 percent of the AIME up to the second bend point, plus 15 percent of the AIME above the second bend point. Another method of reducing initial Social Security benefits would be to lower the three replacement rates by a uniform percentage. For example, lowering the three rates in the benefit formula from 90, 32, and 15 to about 87.0, 30.9, and 14.5, respectively, would achieve a uniform 3.3 percent reduction in the benefits of newly eligible workers--similar to the reduction in benefits that currently eligible workers would incur by forgoing the projected January 1987 COLA. This method would save about $2.7 billion from Social Security outlays over the 1987-1991 period and more in later years.

Under this option, replacement rates for all newly eligible workers would be 3.3 percent lower starting in 1987 than they would be under current law. Thus, a 62-year-old retiree who has always earned the average wage would receive initial benefits in 1987 of about 33 percent of preretirement earnings, compared with 34 percent if no change is made. As with limiting the increase in bend points (ENT-13), this option would substantially reduce future Social Security outlays. It could also be coordinated with a cost-of-living adjustment option to ensure that benefits for both current and future beneficiaries would be reduced to a similar extent. Moreover, unlike the previous option, the percentage reductions in Social Security benefits would be the same for recipients at all benefit levels.

Opponents of cuts in initial benefits contend that it is not necessary to make any permanent reductions beyond those made by the Social Security Amendments of 1983, because the combined assets of the retirement and disability trust funds are expected to be sufficient to pay benefits for at least the next half century. One of the changes made by the 1983 amendments was to increase the age--from 65 to 67--at which unreduced Social Security retirement benefits are first available. The change is to be phased in between the years 2000 and 2022. As a consequence, initial benefits for most workers retiring after the turn of the century are likely to decrease anyway, relative to what they would have received had the full retirement age not been increased. For example, in 2022, a worker who retires at age 62 will receive 70 percent of the Primary Insurance Amount rather than 80 percent; thus, if the worker's replacement rate at age 62 would have been 34 percent, it would instead be about 30 percent under the new rules governing early retirement.

The Administration's budget does not contain any proposals for modifying the Social Security benefit structure.

ENT-15 LENGTHEN THE SOCIAL SECURITY BENEFIT COMPUTATION PERIOD BY THREE YEARS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Outlays	25	100	300	500	700	1,625

Social Security retirement benefits are based on the Average Indexed Monthly Earnings (AIME) of workers in employment covered by the system. At present, the number of years that must be included in the benefit computation formula is determined in part by the year in which the retiree reaches age 62. For example, 30 years are included for those reaching age 62 in 1986; the number is scheduled to increase to a maximum of 35 years for individuals reaching age 62 in 1991 and beyond. Lengthening the averaging period would generally lower benefits, particularly for early retirees, by requiring more low-earnings years to be factored into the benefit computation. One option would gradually add three years to the AIME computation period, basing it on the year the retiree reaches age 65. This proposal, if applied to people turning 62 beginning in January 1987 (but only fully effective after three years), would save $1.6 billion over the next five years and more in later years.

Proponents who favor a longer computation period argue that the number of years included in the calculation of AIME should be based on the age of eligibility for full benefits, not for reduced early-retirement benefits. Doing so would lower Social Security outlays and would reduce incentives for early retirement. Finally, lengthening the averaging period would reduce the advantage that workers with fluctuating earnings have over those with histories of relatively stable earnings.

Because many beneficiaries elect early retirement for such reasons as poor health or unemployment, opponents of this proposal argue that a longer computation period would reduce benefits for those recipients who are least able to continue working. Other workers who would be disproportionately affected include those with significant uncovered periods: for example, parents, usually women, who stopped or interrupted their careers to rear children, and workers who experienced long periods of unemployment or employment not covered by Social Security.

The Administration's budget does not contain any proposals for modifying the Social Security benefit structure.

ENT-16 ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGED 62-64

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Outlays	40	180	350	590	650	1,810

Under current law, unmarried children of retired workers are eligible for Social Security dependents' benefits as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. These benefits help families with children maintain an adequate standard of living after the worker's retirement. A child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64, beginning with retirees reaching age 62 in October 1986, the savings would total about $1.8 billion over the next five years.

This option might encourage some retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under age 18. Thus, workers under age 65 now have an incentive to retire while their children are still eligible for benefits. This incentive would be quite small, however, for families in which spouses are also entitled to dependents' benefits, since the maximum family benefit limits the increase in total benefits attributable to eligible children for these households.

On the other hand, for families with workers whose retirement was not voluntary--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of spouses' entire benefits in some families. In such cases, the total loss of income could be significant.

The Administration's budget does not contain any proposals for modifying the Social Security benefit structure.

ENT-17 COVER ALL NEWLY HIRED STATE AND LOCAL GOVERNMENT WORKERS UNDER SOCIAL SECURITY AND MEDICARE

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.2	1.0	1.7	2.6	3.5	9.1

With the enactment of the Social Security Amendments of 1983, the only major group of the work force who will not eventually be completely covered under Social Security is employees of state and local governments. About 30 percent of such workers are not now covered. If all state and local government workers hired after December 31, 1986, were brought under the Social Security system, federal revenues would increase by about $0.2 billion in 1987 and by about $9.1 billion during the 1987-1991 period. (Approximately four-fifths of these amounts would go into the Old-Age, Survivors, and Disability Insurance trust funds, and the rest would go into Medicare's Hospital Insurance fund.) This option would also result in higher outlays in the future, eventually offsetting a portion of these added revenues, but the increase would be negligible over the next five years.

Many public employee benefit programs have more stringent vesting requirements for such protection than does Social Security, especially for young workers. As a result, Social Security coverage for new state and local government workers would, after only a few years, improve the protection many of these workers and their families would receive in the event of the worker's disability or death. Moreover, since Social Security coverage is portable, workers who change jobs and would lose eligibility for benefits under the state and local plans might find Social Security coverage particularly advantageous. In addition, since the current benefit formula causes some redistribution of benefits from high-wage workers to low-wage workers, it may be inappropriate to allow some groups of workers not to participate.

On the other hand, the transition could be difficult for some of the state and local governments not now participating in the Social Security system, in that they would be providing different retirement packages for new and old employees. Moreover, some critics question the adequacy of funding for current state and local pension plans should new employees no longer be required to contribute to them, and they express particular concern about the fiscal impact this option would have on jurisdictions that operate their pension plans on a pay-as-you-go basis.

The Administration's budget would require states and localities to remit Social Security payments at the same frequency as private employers, but would not change the legislation concerning coverage of their workers.

ENT-18 ELIMINATE VETERANS' COMPENSATION PAYMENTS FOR THOSE WITH LOW-RATED DISABILITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	2,150	2,250	2,350	2,400	2,500	11,650
Outlays	2,000	2,250	2,300	2,400	2,500	11,450

Veterans' disability compensation provides cash benefits to about 2.2 million veterans with service-connected disabilities. Compensation is based on a rating of their impairments and an average reduction in ability to earn wages in civilian occupations. Additional allowances are paid to certain recipients who have dependents. Eliminating all benefits for those with disability ratings below 30 percent, and ending only the dependents' allowances for those with ratings of 30 percent or 40 percent, would reduce federal outlays by about $11.5 billion between 1987 and 1991. Almost 1.3 million veterans would lose all their cash benefits--currently between $68 and $126 per month--but they would retain their eligibility for medical care and other associated benefits. For another 327,000 veterans whose disability rating is 30 percent or 40 percent and who have dependents, benefits would be reduced by an average of about $35 per month.

Advocates believe this option would target benefits toward the most impaired and perhaps the medically neediest of the disabled veterans and their families. It would bring compensation for disabled veterans more in line with workers' compensation programs, which generally provide only temporary cash or medical benefits for low-rated impairments. Moreover, the associated cash payments were originally set in the 1940s when civilian jobs depended more on physical labor than today. Because of the availability of and improvements in reconstructive and rehabilitative medicine, proponents question whether veterans with impairments rated below 30 percent suffer any reductions in their earnings as a result of their low-rated disabilities. Many of these veterans are compensated for low-rated impairments such as mild arthritis, moderately flat feet, or one partially amputated finger, which may not affect their ability to work. Similarly, some proponents argue that the rising participation of women in the labor force means that dependents' allowances for veterans with disability ratings of 30 percent or 40 percent are probably not necessary in most cases to maintain adequate family incomes.

Opponents, however, view these benefits as indemnity payments owed to veterans disabled to any degree while serving in the armed forces. Furthermore, some beneficiaries have retired from work and rely on pension incomes, so that even a small reduction in payments could have a greater impact on them than on younger veterans.

An alternative option would be to reduce or eliminate benefits to veterans with low-rated disabilities who have already received their benefits for more than a certain number of years. For example, eliminating compensation payments after two years for those veterans with disabilities rated below 30 percent would result in large program savings over the next five years.

The Administration's budget would not change the eligibility criteria for veterans' compensation.

ENT-19 REQUIRE A TWO-WEEK WAITING PERIOD FOR UNEMPLOYMENT INSURANCE BENEFITS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	--	--	--	--	--	--
Outlays	--	930	970	980	1,020	3,900

NOTE: These estimates assume that the change is not implemented until fiscal year 1988, to allow time for changes in state Unemployment Insurance laws.

Current federal law imposes no mandatory waiting period before jobless workers can receive their initial Unemployment Insurance (UI) benefit payment. The Omnibus Reconciliation Act of 1980 did, however, require states to adopt a one-week waiting period on regular UI benefit payments or lose some federal benefits under the extended UI program. Forty-three states now require a one-week waiting period for regular UI benefits; the remaining states have no waiting requirement.

If all jobless workers were required to wait two weeks before receiving UI benefits, program outlays would be reduced and beneficiaries in all states would be treated uniformly. Such a change would not affect the maximum length of time during which workers could collect benefits--for example, a person otherwise eligible for 26 weeks of benefits would retain that eligibility but would receive payments during weeks 3 through 28 of joblessness. Benefits would be reduced, however, for those recipients not using the maximum number of covered weeks. If implemented in 1988 (to allow time for states to change their UI laws), this option would cut total UI outlays by $3.9 billion between then and 1991. 1/

This option could significantly reduce the work disincentive of UI by increasing the initial cost of being unemployed, yet it would not greatly affect the program's ability to help the long-term unemployed. This restriction of aid might also lower the number of workers who apply for assistance, in addition to reducing the duration of benefits paid to many who do apply.

---

1. See CBO, *Promoting Employment and Maintaining Incomes with Unemployment Insurance* (March 1985), p. 48.

On the other hand, critics point out that because this change would reduce the benefits provided to jobless workers who do not use all of their entitlement, it would diminish the income support role of UI. In addition, opponents maintain that covered workers are entitled to benefits when they become unemployed, and that this change would erode the insurance protection of unemployment insurance even for those who eventually exhaust their entitlement. Finally, some people oppose this change because it would impose additional federal restrictions on state UI programs, even though it is state UI taxes that finance regular UI benefits.

The Administration's budget would not change the waiting period for Unemployment Insurance benefits.

ENT-20 INDEX THE UNEMPLOYMENT INSURANCE TAXABLE WAGE BASE

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	--	0.3	0.7	1.0	0.8	2.8

NOTE: These estimates assume that the change is implemented in January 1988, to allow time for changes in state laws. Further, some states with Unemployment Insurance programs in good financial condition are assumed to offset increases in the tax base with reductions in their tax rates.

The joint federal/state Unemployment Insurance (UI) program is financed primarily through federal and state payroll taxes on employers. The federal UI taxable wage base--which also serves as the minimum base for state UI taxes--is currently $7,000 per worker and has been increased only three times from its level of $3,000 in 1940. The proportion of total wages subject to the federal tax has thus fallen from over 90 percent in 1940 to about 40 percent now. In contrast, UI benefits tend to increase with nominal wages, because benefits are based in part on prior earnings and because many states index their maximum weekly benefit to average weekly wages. Indexing the federal UI wage base by linking it to average earnings in the national economy--as is done with the Social Security base--would increase revenues, and thus reduce the federal budget deficit, by about $2.8 billion over the 1987-1991 period. [1]

This option could help to stabilize the long-term financial position of the UI system by allowing revenue increases to follow a path similar to benefit gains. Raising the minimum state tax base could also allow for reductions in the tax rates of some states, which have risen from an average of 1.3 percent of taxable wages in 1970 to about 3.1 percent in 1985. Finally, by concentrating the tax increase on the wages of workers now earning more than the current tax base, this change would make the UI tax somewhat more progressive.

---

1. See CBO, *Promoting Employment and Maintaining Incomes with Unemployment* (March 1985), p. 54.

Because this change could result in higher labor costs for employers, however, it might adversely affect employment levels. In addition, mandating increases in minimum wage bases for state UI taxes would limit somewhat the flexibility of states in designing tax systems to finance their UI benefits. Although states in good financial condition could offset the total amount of this change by lowering tax rates, there would be some redistribution of tax payments by different firms.

The Administration's budget would not modify the present Unemployment Insurance taxable wage base.

ENT-21 REDUCE GUARANTEED STUDENT LOAN SUBSIDIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Require Students to Pay In-School Interest						
Budget Authority	-95	560	970	1,200	1,300	3,950
Outlays	-50	390	870	1,150	1,300	3,650
Raise Students' Interest Rates After Leaving School						
Budget Authority	--	20	85	150	200	450
Outlays	--	15	65	140	190	400
Reduce Lenders' Subsidies by One-Half Percentage Point						
Budget Authority	25	70	120	160	200	560
Outlays	15	60	100	150	190	510
Reduce Default Costs						
Budget Authority	--	25	110	160	180	470
Outlays	--	25	110	160	180	470

NOTE: The savings that would result from implementing all four options jointly would not equal the sum of the separate estimates because the options would interact.

Postsecondary students borrowing money under the Guaranteed Student Loan (GSL) program repay their loans after leaving school at interest rates between 7 percent and 9 percent--well below interest rates for unsecured personal loans. The federal government guarantees the loans, which lending institutions provide, and pays the interest while students are enrolled in school. In addition, during the entire life of the loan, the government pays lenders a variable amount that supplements students' interest payments, guaranteeing lenders a return equal to 3.5 percentage points above the bond equivalent rate for 91-day Treasury bills.

Two main objectives underlie federal support for GSLs: to provide more financial aid to needy students, and to make loans available to students who would encounter difficulties in obtaining private loans because they lack collateral. The first objective suggests that the government would subsidize loan terms for students; the second objective suggests that the government would reduce imperfections in the capital market but would subsidize students much less or not at all. Furthermore, because the federal government both bears the risk of rising interest rates and insures loans against default, the payments provided to lending institutions are probably higher than necessary to induce lenders to provide GSLs to students.

The Congress could reduce federal spending on student loans in several ways. For example, students' subsidies could be reduced by requiring students to pay the interest on loans while in school--the "in-school" interest--or by requiring borrowers to repay their loans at higher interest rates. Alternatively, the yield provided to lenders could be lowered, or default costs could be reduced. These options are discussed below.

Require Students to Pay In-School Interest or Raise Students' Interest Rates After Leaving School. Making students pay between 7 percent and 9 percent interest while they are in school (eliminating the student origination fee and deferring actual payments until the student leaves school) could reduce federal outlays by $3.65 billion between 1987 and 1991. Raising students' interest rates after they leave school to the full interest the government now pays to lenders, but continuing the in-school interest subsidy, could reduce federal spending by $400 million during the 1987-1991 period and by more in future years. Both estimates assume that the options would affect only loans obtained after October 1, 1986, and that the number of borrowers would continue at the level now expected. If some students were to drop out of the program, federal savings would be greater.

Proponents argue that even a 9 percent loan with no payments until students leave school is more than generous enough to enable students to obtain further education, especially for students from middle- and higher-income families. Both options would reduce the subsidy by requiring students to repay larger amounts. Letting students borrow the in-school interest at the time loans are made would give banks a similar yield as now, but borrowers would still not have to make any payments while attending school. Raising interest rates after students leave school would require larger repayments than under current law, but the increase generally would be smaller than if the in-school interest subsidy were eliminated and students borrowed the interest at loan origination.

Opponents of these changes--especially of the option to eliminate the in-school interest subsidy--argue that larger repayment burdens would cause some students to leave school or to choose different institutions. In addition, opponents claim that some lenders might drop out of the program because of somewhat increased servicing costs and complexity, thereby making it more difficult for students to obtain loans. If loan availability declined, however, some colleges and universities might increase their own student aid to offset the reductions in GSLs.

Reduce Lenders' Subsidies. This option would lower the interest supplement paid to lenders while students are in school, when lenders' servicing costs are lowest. Each reduction of one-half of a percentage point in the yield on new loans while students are still in school would lower spending by $510 million during the next five years.

Current GSL subsidies are probably higher than necessary to induce lenders to participate in the GSL program because the federal government bears all risk of rising interest rates and insures the loans against default. Moreover, reducing lenders' subsidies would lower program expenditures while not affecting students' costs. On the other hand, this approach could cause some lenders to stop providing GSLs and thus make loans more difficult for students to obtain. The effect would probably differ across the country, however, depending on the response of local lenders.

Reduce Default Costs. Federal default costs could be controlled in two ways. One option is to enforce more strictly "due diligence" provisions that lenders must now follow when collecting loans. Another option is to restore a previous coinsurance provision that required state guarantee agencies to pay a portion of default costs. These options would lower federal outlays by $470 million during the next five years if implemented jointly and if the coinsurance provision were applied to new loans only.

Under this approach, most lenders and state guarantee agencies would expand their efforts to prevent defaults. Some lenders or state agencies might drop out of the program, however, making loans more difficult to obtain. Alternatively, states might shift some of their default costs to students--most of whom do not default--by increasing the insurance premiums that students pay when obtaining loans.

The Administration's GSL proposal would affect students, lenders, and guarantee agencies. The proposed changes are similar to those discussed here, but the proposal would reduce federal subsidies substantially more than these cutbacks. For example, the Administration would require students to pay the in-school interest, as presented here, and would continue the 5 percent student origination fee.

ENT-22 REDUCE THE SUBSIDY FOR NONPOOR CHILDREN IN CHILD NUTRITION PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	280	300	320	330	350	1,580
Outlays	250	290	310	330	350	1,550

Federal child nutrition programs were developed to improve the health and well-being of children by providing them with nutritious meals. The programs provide cash and commodity assistance to schools, child care centers, and family day care homes that serve meals to children. Although most of the funds are targeted toward low-income children, some of the aid benefits middle- and upper-income children as well. For example, in the National School Lunch program (the largest of the child nutrition programs), most schools receive $1.30 in cash reimbursement for each meal served to children from households with incomes at or below 130 percent of the poverty line; a reduced subsidy of 90 cents for each meal served to children from households with incomes between 130 percent and 185 percent of poverty; and a subsidy of 12.5 cents per meal for children with household incomes above 185 percent of poverty. Schools are also given 12 cents' worth of commodities for each lunch served, regardless of the household income of the child. Comparable reimbursement structures are used in the School Breakfast program and in the child care center portion of the Child Care Feeding program.

Eliminating the cash reimbursement for all meals served to children from households with incomes above 185 percent of the poverty line ($19,703 per year for a family of four in the 1985-1986 school year) would reduce federal expenditures by about $250 million in 1987, and about $1.55 billion over the 1987-1991 period. These estimates assume that all participating schools and child care centers would remain in the program. With lower total subsidies, however, some of these organizations might choose to drop out of the program, especially if few children remained eligible for federal subsidies. A decrease in the number of schools and centers participating would increase federal budgetary savings, as fewer children and organizations would receive subsidies.

Proponents of this change point out that, although most of the federal funds were targeted toward low-income children, 51 percent of the school lunches served in fiscal year 1985 went to children whose family income was above 185 percent of the poverty line. They argue that these children do not need federal subsidies and that the targeting of this assistance would be improved by limiting it to those most in need.

Opponents point out that such a change is likely to result in decreased participation among nonpoor children, as participating schools and centers would probably make up the loss in reimbursements by increasing the price charged to this group. It is not known, however, how many children are likely to drop out of the program. Opponents are concerned about the potential decrease in participation for several reasons. First, they argue that meals qualifying for reimbursement are nutritionally superior to those from alternative sources, and that eliminating subsidies for nonpoor students could result in lower-quality meals for them. Second, they are concerned that if large numbers of nonpoor children drop out of the program, low-income children could become the main recipients of the meals and thus would be identifiable as poor by their peers. Finally, they maintain that because the participation of nonpoor children may help schools and child care centers hold down their overall per-meal preparation and service costs, any decline in the participation of this group could cause these organizations to drop out of the program, thereby denying federally subsidized meals to low-income children.

The Administration's budget includes the proposal described above. In addition, it would eliminate both commodity subsidies for meals served to children with family incomes above 185 percent of poverty and cash and commodity subsidies for such children in the family day home portion of the Child Care Feeding program. These changes would lead to substantially larger savings.

ENT-23 REDUCE AND RETARGET AID FOR DEPENDENT CARE

Savings from CBO Baseline	Annual Savings (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Gross Revenue Gain	0.2	1.7	1.9	2.1	2.3	8.2
Outlays a/	-0.1	-0.85	-0.95	-1.05	-1.15	-4.1
Net Savings	0.1	0.85	0.95	1.05	1.15	4.1

a. Negative numbers reflect increased outlays for the SSBG (see text) and assume 100 percent spend-out of additional SSBG budget authority in each year.

Two of the ways in which the federal government provides financial support for dependent care are through the Dependent-Care Tax Credit and the Social Services Block Grant (SSBG). The tax credit permits taxpayers to claim a specified percentage of employment-related expenses for care of children under age 15 and certain other dependents. The credit is granted on a sliding scale--30 percent of up to $4,800 in allowed expenses for taxpayers with adjusted gross incomes (AGI) of $10,000 or less, declining one percentage point for each additional $2,000 of AGI to 20 percent for those with incomes above $28,000. The SSBG funds a wide variety of social services, including day care for children and other dependent people.

Tightening the tax credit and expanding the SSBG--with the stipulation that the additional funds be used for dependent care for low-income families--would both reduce the deficit and expand services for those most in need. The tax credit could be more steeply graduated, declining by one percentage point for each additional $1,000 of AGI over $10,000, phasing out completely for those with an AGI above $39,000. If half of the savings were applied to the grant program, net savings would be $0.1 billion in fiscal year 1987 and $4.1 billion over the 1987-1991 period. The Administration's most recent tax reform proposal would retain the current Dependent-Care Tax Credit, as would the tax reform bill passed by the House of Representatives, H.R. 3838.

This option would help meet the growing need for dependent-care services for low-income families. For example, about 5.1 million children under age 6 lived in poverty in 1984--an increase of almost 2 million since

1979--and nearly half lived in single-parent households headed by a woman. The families of these children can have difficulty obtaining high-quality child care without assistance, and because of their low incomes, few benefit from the tax credit. This option would also reduce work disincentives for some low-income parents.

On the other hand, these measures would require a partial reversal of some recent changes in federal support for dependent care. In creating the SSBG in 1981, the Congress removed the requirements of the predecessor program (Title XX) that benefits be targeted by income and that a specified amount of funding be spent on child care. Moreover, tightening the credit would adversely affect some families--including some with incomes below the median--by increasing their tax liabilities.

ENT-24 TERMINATE GENERAL REVENUE SHARING

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	4,550	4,550	4,600	4,600	4,600	22,900
Outlays	3,350	4,550	4,600	4,600	4,600	21,700

The General Revenue Sharing (GRS) program, established in 1972, provides more than $4 billion annually in unrestricted grants to all local governments--counties, municipalities, townships, and Indian tribes. State governments also participated until 1981, when their share was eliminated on the ground that their fiscal condition no longer warranted federal subsidies. Federal savings of $3.4 billion in 1987 and $21.7 billion over the 1987-1991 period would be realized by allowing the authorizing legislation for the GRS program to expire at the end of 1986.

Proponents of terminating the program argue that, under current economic circumstances, federal aid should be targeted toward programs with clear national policy objectives rather than toward programs such as GRS that place no restrictions on expenditures. They argue further that since GRS payments represent less than 2 percent of total revenues of local governments, the impact on local fiscal conditions would be small.

Advocates of maintaining the program would argue that, over the last decade, GRS has been figured into the budgets of its recipients. Because GRS makes up a substantial portion of revenues for some jurisdictions, ending that support could impose at least temporary stress on them, particularly in view of cutbacks in other federal assistance programs. Indeed, some argue that the "no strings attached" nature of GRS makes it a model for federal assistance and that categorical aid programs are the ones that should be pared.

In the 1986 budget resolution, the Congress assumed that the General Revenue Sharing program would be terminated at the end of fiscal year 1986. The Administration's budget also does not seek reauthorization for the program and proposes to rescind the last quarterly payment to be made with funds from fiscal year 1986.

AGRICULTURAL PRICE SUPPORTS

This category presents three options for reducing agricultural price-support expenditures. Each option would reduce crop deficiency payments, which are projected to total about $45 billion over fiscal years 1987-1991 and account for about 50 percent of total price-support outlays.

Deficiency payments support the incomes of feed grain, wheat, rice, and cotton producers when national average prices for a specified period fall below target prices. To be eligible for deficiency payments, a producer must voluntarily participate in acreage reduction programs and forgo production, and hence income. Because deficiency payments are made in proportion to production, they are concentrated among the nation's largest producers--in 1984 about two-thirds of payments went to 14 percent of the largest farms.

The three options are not mutually exclusive. AGR-01 would reduce deficiency payments by lowering target prices at a faster pace than required under current law. AGR-02 would eliminate deficiency payments on acreage in excess of that needed to meet projected utilization. AGR-03 would reduce income support to the largest farms by lowering the amount of payments that individual producers can receive.

AGR-01 REDUCE DEFICIENCY PAYMENTS BY LOWERING TARGET PRICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	500	2,040	2,940	2,790	2,350	10,620
Outlays	500	2,040	2,940	2,790	2,350	10,620

Target prices for grains are frozen at current levels for the 1986 and 1987 crops. The Secretary of Agriculture can reduce them by 2 percent in 1988, 3 percent in 1989, and 5 percent in 1990. (Cotton and rice target prices are frozen for 1986 and then will be reduced by 2 percent, 3 percent, 3 percent, and 2 percent over 1987-1990, respectively.) While target prices are frozen for 1986 and 1987, price supports will be reduced, which will increase the level of income support--the maximum level of support being the difference between the target price and the support price. This in turn will mean higher deficiency payments. An alternative would be to reduce target prices by 5 percent per year starting in 1987. Outlay savings would be $10.6 billion over the 1987-1991 period.

A more rapid rate of reduction in the level of income support would increase the pace at which farmers would respond to market prices rather than to government target prices. Such a reduction in the level of income support would be consistent with a market-oriented farm policy as envisaged under current law. Because of the concentration of deficiency payments among a relatively small number of larger-than-average crop farms, this alternative would not have much effect on most farmers' incomes.

Some farmers no doubt would be harmed more than others by a faster reduction in target prices. In 1984, about a fourth of government payments went to financially stressed farms with debt-to-asset ratios above 40 percent and negative cash flows. Further, this option would tend to weaken the effectiveness of acreage reduction programs by reducing the incentives to participate.

AGR-02 ELIMINATE DEFICIENCY PAYMENTS ON EXCESS ACREAGE

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	470	2,450	2,980	1,420	1,025	8,345
Outlays	470	2,450	2,980	1,420	1,025	8,345

Crop farmers receive deficiency payments if they agree to reduce the acreage planted to a program crop. Payments are based on the acreage planted to a program crop multiplied by a farm's program yield. According to CBO projections, crop acreage on which payments are made exceeds the acreage estimated to be necessary to produce for domestic use, exports, and stock requirements. If deficiency payments were limited to the acreage needed for projected use, savings would be $8.4 billion over the 1987-1991 period.

The current payment structure encourages production: farmers tend to produce in response to target prices and expected government payments. In conditions of surplus production, such incentives lead to lower prices and higher government outlays, since surplus production ultimately ends up under government loan or ownership. This option would directly result in budgetary savings by reducing total deficiency payments. Further, to the extent it caused any contraction in production, savings in lending and acquisition costs might result.

Since government payments would be reduced under this option, farmers as a group would be somewhat financially worse off as a result. Most participating farmers would not be affected much, however, given the relatively small importance of government payments to them. This option could also impair the effectiveness of acreage reduction.

AGR-03 REDUCE DEFICIENCY PAYMENTS BY LOWERING PAYMENT LIMITATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	0	2,030	2,160	1,930	1,515	7,635
Outlays	0	2,030	2,160	1,930	1,515	7,635

Since crop deficiency payments are in proportion to production, they benefit primarily large-scale commercial farmers. An alternative would be to place further limits on government payments to large farmers by reducing the annual amount of government payments an individual farmer may receive. One option would be to hold deficiency payments and diversion payments to $10,000 per farmer as compared with the current $50,000 limit. (The limitation does not apply to all payments.) If this was first applied to the 1987 crops, savings would be $7.6 billion over the 1988-1991 period.

Proponents point out that large crop farms generate much higher than average incomes so that these farms do not need as much income assistance. In 1984, about two-thirds of government payments went to farms that had average incomes of about $55,000 per household and average equity of about $600,000 each. This option would reduce income transfers to the largest farms, especially those producing cotton and rice. Many farms would not be affected much by a $10,000 limitation, since they would receive about the same income support as they do currently.

Some farmers would be worse off under a tighter payment limitation. This approach would not be very effective for targeting income support to farmers with the greatest need. Farm size is a poor way of determining economic need since there is great diversity among crop farmers' incomes. Further, a lower payment limitation would likely discourage some farmers from participating in acreage reduction programs, thereby reducing the effectiveness of supply management. Last, farms can be redefined so as to make more individuals eligible for payments, thus reducing outlay savings.

NONDEFENSE DISCRETIONARY SPENDING

Over the past several years, outlays for nondefense discretionary spending have been reduced substantially. Further small, incremental reductions are not likely to achieve significant savings, and may limit the effectiveness of programs to the point where they no longer can meet policy objectives. In light of the requirements of the Balanced Budget Act, the Congress may instead wish to consider a number of possible strategies that would either eliminate or significantly reduce selected programs. At the most basic level, the Congress can choose a sweeping, across-the-board strategy based on the notion that the government should stop providing many of the services contained in this part of the report. Or, it can develop a program-by-program approach, trying to effect budgetary savings in each individual area by consolidating services, targeting them more narrowly, or charging users for them, depending on the specific program in question.

NDD-01 through NDD-05 represent the across-the-board approach. These options call for sweeping changes in nondefense discretionary programs, including eliminating or severely reducing most federal aid to infrastructure, energy, business, construction, and foreign development.

The second approach--specific program cuts--is taken in the remaining options. NDD-06 through NDD-09 propose revenue gains by recovering costs from program users. The remaining options are organized largely by functions of the federal government. NDD-10 through NDD-16 cover infrastructure (including transportation); NDD-17 through NDD-20 relate to commercially oriented activities of the federal government; NDD-21 through NDD-31 include options related to community and human resources.

Many of the program reductions or deletions suggested by NDD-10 through NDD-31 are also proposed by the across-the-board cuts, the primary difference being the underlying philosophy that motivates the option. Reducing the share of mass transit costs covered by the federal government, for example, is suggested by NDD-14 on the grounds that the current high federal matching ratio provides little incentive for localities to propose the most cost-effective projects. It is also suggested, however, by NDD-01 as part of an overall option to remove the federal government from all infrastructure programs that provide primarily local benefits.

NDD-01 WITHDRAW MOST FEDERAL AID FOR PUBLIC WORKS INFRASTRUCTURE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Eliminate Most Aid						
Budget Authority	23,000	26,000	28,000	29,000	30,500	136,500
Outlays	8,600	17,000	20,800	23,600	25,700	95,700
Phase Out Aid						
Budget Authority	2,900	6,500	10,500	14,500	19,000	53,400
Outlays	1,100	3,300	6,900	10,700	14,900	36,900

The federal government spends more than $30 billion a year to help build, maintain, and operate the nation's public works infrastructure and related services. State and local governments spend an additional $60 billion each year. Only about one-fourth of federal funds are used for operations and maintenance, whereas state and local governments devote two-thirds of their public works spending to those purposes.

By now most of the infrastructure the nation requires is already in place, as a result in large part of federal efforts.[1] The overriding national goal today is to maintain, not build, these systems. What need there is for added capacity is concentrated largely in fast-growing localities. One option, therefore, would be to limit federal aid to meeting those needs that are entirely national in purpose: basic research, safety, and a few other areas with primarily cross-jurisdictional economic effects, such as the Interstate Highway System. The remaining areas of spending would either be eliminated immediately or phased out over the coming few years. The major rationale for such a reduced federal involvement in infrastructure spending is that the benefits of most infrastructure projects go primarily to localities. Further, some federal programs encourage inefficiency in public investment.

---

[1] See CBO, *Public Works Infrastructure* (April 1983) and *The Federal Budget for Infrastructure* (July 1985).

By the end of the decade, 95 percent of the infrastructure spending now done by the federal government could be shifted to nonfederal governments or the private sector, or could be financed through increased federal user fees. Outlay savings would total $8.6 billion in 1987, reaching $25.7 billion by 1990, and approaching $100 billion throughout the 1987-1991 span. Budget authority savings would be substantially greater for 1987 and 1988 because of the normal delays between the authorization to sign a contract and payment once work has been completed.

Though the details of such a proposal could vary, one set of changes would involve 10 federal programs in the following ways:

Highways. Limit federal aid to repairs on the Interstate Highway System and to certain research and safety programs. Nonfederal financing could be encouraged by permitting tolls on existing federal-aid roads (see also NDD-15). [2]

Transit. Eliminate all grants except those going toward safety and a limited research program (see also NDD-14).

Aviation and Aerospace. Eliminate grants to airports and turn the air traffic control system over to an independent public corporation. Trim NASA's research program to basic research and areas with long-range potential (see also NDD-08).

Wastewater Treatment. Phase out the EPA grant program by eliminating all new projects (see also NDD-16).

Rail. Eliminate aid to Amtrak and limit the federal role in railroads to safety (see also NDD-13). Sell Conrail if bids can be raised to higher levels than those already submitted.

Army Corps of Engineers. Eliminate all construction programs and impose full user fees for maintenance work. Limit Corps activities to maintenance work while local and/or private groups take over other responsibilities (see also NDD-11 and NDD-12). (Exceptions could be made if user fees were extended and increased to recover full Corps costs.)

Bureau of Reclamation. Eliminate all new construction and impose full user fees as contracts expire.

---

[2] See CBO, *Toll Financing of U.S. Highways* (December 1985).

Water Supply. Eliminate all aid.

Coast Guard. Eliminate all aid except the Coast Guard's drug and territorial enforcement activities, and research and safety projects. Continue Coast Guard search and rescue and aids to navigation only if they could be financed completely from user fees (see NDD-09).

Maritime Administration. Eliminate cargo preference rules and other subsidies except for existing long-term contracts for maritime operating subsidies (see NDD-10).

The disruptions caused by such drastic changes would vary considerably, with limited long-run problems for those areas that have the potential to be financed through user fees--highways, airports, air traffic control, ports and harbors, locks and dams, and most water resource projects.[3] Though higher--and in some cases, altogether new--fees would be required, one result would be a strong impetus to select more cost-effective projects and to operate them more efficiently than under the current system of federal subsidization. The most serious negative effects would be focused on activities that cannot be completely self-supporting: most mass transit, Amtrak outside the Northeast Corridor, and projects in depressed areas. These would require either massive restructuring or increased local taxes. Without federal control, there would be fewer safeguards against actions in one locality jeopardizing those in others.

Adversities could be eased somewhat by gradual rather than quick action. A phaseout could be implemented by systematically reducing the federal matching share for those programs in which costs are shared with nonfederal governments, and by graduating downward new budget authority for other programs. For example, if the current 80 percent federal share of transit capital grants were reduced by 10 percent a year, the program would be eliminated in eight years. Such a phase-down would allow state and local governments some time to develop alternative means of finance. Between 1987 and 1991, federal budgetary savings would be about 40 percent of those produced by immediate elimination, or $37 billion.

The magnitude of the savings assumes that existing federal user fees (the nine-cent-per-gallon tax on motor fuel, for example, and the 8 percent airline ticket tax) would be continued, with receipts paid into the general fund of the U.S. Treasury. If these taxes were reduced in line with the program reductions, the potential savings to the federal budget would be cut by 60 percent, to about $10 billion a year. The estimates also assume no offset from reduced income tax receipts as new state and local fees are imposed, nor from increased federal tax expenditures as greater use is made of the tax-free bond market. These offsetting effects could reduce the gross budgetary savings by about one-third.

---

[3] See CBO, *Charging for Federal Services* (December 1983) and *Financing U.S. Airports in the 1980s* (April 1984).

The Administration proposes major cuts in three of the areas considered here: railroads, with aid to Amtrak eliminated; transit, where all operating aid and some two-thirds of capital assistance would be dropped; and wastewater treatment, where aid would be phased out over the next three years. Spending for most other infrastructure programs would be held below that assumed by the CBO baseline.

NDD-02 REDUCE SUPPORT FOR ENERGY SUPPLY, CONSERVATION, AND THE STRATEGIC PETROLEUM RESERVE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	2,650	3,000	3,500	3,800	4,000	17,000
Outlays	1,300	2,450	3,200	3,600	3,850	14,400

The Department of Energy (DOE) supports efforts to develop energy resources, conduct research on new and nonconventional energy-generation technologies, and improve conservation; it also has responsibility for acquiring and storing oil in the Strategic Petroleum Reserve. Most of the federal funding going toward these activities is intended to complement, not substitute for, private-sector investment. Some of the DOE funding, however, is necessary to support regulatory activities; some is deemed important to the nation's security; and some is of a scale that only the public sector can afford. If federal support were withdrawn from all but the most critical activities, outlays could be reduced by $14.4 billion over the 1987-1991 period. This sharp reduction of federal support would affect three main categories in the DOE energy budget: supply, conservation, and the Strategic Petroleum Reserve. This would leave many activities to be funded completely by the private sector as determined by market needs.

The DOE's energy supply activities include two main funding areas that could be eliminated or curtailed: research and development (R&D) and subsidies to nonconventional fuel production. In energy R&D, all support for research programs in fossil fuels, solar and renewable resources, energy science, and miscellaneous other areas could be eliminated, assuming that the private sector would continue to support research efforts that appeared commercially promising. Federal support for civilian research in fission power (except funding for cleaning up uranium mine wastes) would also be eliminated because of this technology's high degree of commercialization and the ability of the private sector to conduct appropriate research. (However, because the private sector could not reasonably be counted on to continue fusion R&D, which has little immediate commercial value, federal funding in this area would continue.) In addition, halting support for nonconventional fuel production would curtail future appropriations (not including the $400 million already earmarked) to develop clean coal technologies. Elimination of appropriations for all energy supply activities would result in estimated outlay savings of $1.23 billion in 1987 and $11.6 billion over the 1987-1991 period. Such savings would be significantly greater than under the Administration's proposed budget, which seeks to reduce but not eliminate federal support in these programs.

In energy conservation, all support for R&D could be curtailed and transferred to the private sector. In addition, grants made to states and local governments to weatherize schools, hospitals, and the homes of low-income families could be curtailed, allowing states to decide whether to continue such support. Total federal outlay savings in these areas would amount to $80 million in 1987 and $1.82 billion over the 1987-1991 period.

DOE is responsible for the construction and maintenance of the Strategic Petroleum Reserve (SPR), and for the acquisition of oil to fill the reserve. The original intent of the SPR, authorized in 1975, was to mitigate the economic problems that can result from full or partial interruption of oil imports to the United States. The SPR will contain roughly 500 million barrels of crude oil by the end of 1986, with 750 million barrels being the eventual goal. Additional unobligated balances of oil acquisition funds would allow DOE to fill the reserve to a level of approximately 520 million barrels. At the 520-million-barrel level, the SPR could meet current U.S. oil import demand for 100 to 125 days (about 30 days of total U.S. demand), with privately held reserves able to meet 35 to 40 days of import demand (about 10 days of total U.S. demand). Today, the U.S. economy depends less on imported petroleum than it did 10 years ago, and oil supplies are abundant and available from various sources. In light of these recent shifts in the oil market (including continuing pressure to reduce prices), further purchases for the SPR could be eliminated or suspended, saving approximately $827 million in outlays over the 1987-1991 period. In addition, planned capital improvements and distribution enhancements to the reserve could be eliminated, saving $151 million over the 1987-1991 period. (This proposal is similar to the Administration's policy initiative, which also seeks to halt funding of the SPR after reaching a capacity of 500 million barrels.)

By reducing federal support in the areas mentioned, many costs would be transferred to states and local agencies or to the private sector. Problems could result if either decided not to fund projects previously backed with federal dollars. For example, research in the area of nuclear plant safety and improvement could lag if federal efforts in this area ceased. Similarly, weatherization of homes of low-income families could be curtailed, forcing hardship on some people. And if, contrary to present expectations, oil prices were to increase and supplies to become short, the federal government's current opportunity to buy oil at low prices would have passed.

NDD-03 ELIMINATE FEDERAL SUBSIDIES TO BUSINESS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	1,900	3,500	3,300	3,900	4,300	17,000
Outlays	1,100	2,900	3,900	4,600	5,000	17,500

Nonfarm U.S. businesses receive federal assistance through a wide assortment of grants or subsidized credits. This spending is scattered among many agencies and accounts. The most obvious programs subsidizing nonfarm businesses include the Small Business Administration (SBA), Export-Import Bank (Eximbank), and the Rural Electrification Administration (REA). The list of federal subsidies for business is, however, much longer. The economic development activities of the Economic Development Administration (EDA), the Urban Development Action Grant (UDAG) program, and the Community Development Block Grant (CDBG) program also support business. Besides providing insurance for foreign investment, the Overseas Private Investment Corporation (OPIC) also provides subsidized business loans and loan guarantees.

No unifying vision or strategy underlies these programs. Rather, they emerged one-by-one, as specific markets came under criticism as being unresponsive to certain public needs. Long after the market imperfections that these programs were designed to overcome had been corrected, however, many of them have continued. Advocates of cutting them would also note that many of these programs fail to meet the business development goals set out for them. In a general sense, subsidies for one type of business usually come at the expense of another. Especially in the case of many economic development grants, the federal subsidies often do not create new businesses; instead, they encourage cities and states to compete for the businesses that already exist.

Supporters of these programs, however, often cite a past record of worthwhile actions, and argue that terminating them could result in undue losses to current recipients, most of whom have not experienced any windfall gain because they bought into the business when the subsidies were already capitalized.

Ending these subsidies would save an estimated $1.1 billion in 1987 and $17.5 billion over the five-year period. To save the sums these programs cost, the Congress would have to end all SBA new lending (though management and technical assistance, especially for minority enterprises, could be excepted to continue at a small cost), terminate the Eximbank, cut REA loans and loan guarantees, cut EDA, CDBG, and UDAG grants that directly aid business, and end OPIC loans and loan guarantees. (See also NDD-18, NDD-24, and NDD-25.)

As an alternative to terminating the REA programs, the Congress could reduce program subsidies by charging an up-front fee on new loans to cooperatives to cover costs of loan defaults or other losses. Assessing a fee based on the projected cost to the government of these defaults could reduce the deficit by about $0.7 billion over the 1987-1991 period, and would continue lending to cooperatives at below the market rates.

NDD-04 SCALE BACK NONDEFENSE CONSTRUCTION PROJECTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority a/	2,200	1,750	1,750	1,800	2,000	9,500
Outlays	800	1,550	1,850	1,950	2,050	8,200

a. In some accounts reductions in construction activity do not reduce budget authority. In addition, reductions from prior-year balances are assumed to reduce budget authority required in 1987.

The federal government currently disburses some $9 billion a year for contracts it awards for nondefense capital improvements. About four-fifths of this amount goes for water, energy, and other natural resource projects, for Veterans Administration (VA) hospitals and nursing homes, and for U.S. Postal Service facilities. A one-third cutback in Executive Branch capital investments, financed either from new funding or unobligated balances on hand at the start of 1987, could produce outlay savings through 1991 in excess of $8 billion. The Congress could provide guidance on how to allocate the cuts or leave such decisions entirely to the Executive Branch. (The estimated cutback excludes costs for administration of public works and funds appropriated to the President for military and economic assistance.)

A one-third cut in the real level of nondefense purchases of lands, structures, services, and equipment that support public works improvements would be much more severe than proposals in the President's budget or than would be effected in the event of a 1987 sequestration under the Balanced Budget Act. Compared with a sequestration, this option proposes a percentage cut four times larger and applies it to a broader base that includes unobligated balances from prior-year funds, federal power authorities, and the U.S. Postal Service. As such, this proposal offers one way of achieving large savings without cutting nondefense human resources activities or defense activities. Moreover, the cutback would improve flexibility in future budgetary decisionmaking, because the federal commitment to projects that require payments over several years would be smaller. In response to reduced funding, agencies would have to reassess capital investment needs, determine which projects have highest priority (on the basis of cost/benefit analysis and other criteria), and apply better approaches to construction management such as those covering design specifications and cost-effectiveness reviews.

In general, opponents of such a cutback maintain that, despite the best of intentions, the reductions would likely apply across the board on a pro rata basis. This would tend to separate program from capital investment decisionmaking, disrupt orderly public works management, and create difficulties for some agencies in meeting mandated obligations to deliver services. For three of the major types of investments potentially affected, arguments for and against a cutback could include the following. 1/

Water and Other Natural Resource Projects. Spending for federal water resource projects (mostly by the Army Corps of Engineers and the Bureau of Reclamation) has declined in real terms in recent years, largely because of an impasse over user fees and cost-sharing policies. Some observers maintain that, if the commercial users and local governments that benefit from these projects are unwilling to pay for them, most projects should be curtailed, if not phased out altogether. In addition, some proponents of a cutback in natural resource construction believe that many projects are not economically feasible, and that the federal government already has too many projects that will require substantial resources in the future for maintenance and repair. On the other side, opponents of deep funding cuts maintain that the age of current facilities justifies continuation of current funding even though the balance between new projects and major repairs might shift. Opponents also argue that cutbacks would foreclose an opportunity to help two troubled industries, inland barge transport and farming. (Other approaches to cutting funds that support federal construction of energy and water resource projects include NDD-01, NDD-02, NDD-11, and NDD-17.)

Veterans Facilities. Funds for construction of VA hospitals and major health care facilities, including amounts from prior appropriations, now total about $1.8 billion. Inpatient hospital care is provided on a space-available basis, with first priority given to veterans with service-connected injuries or illnesses. Proponents of reduced VA construction funding believe the system

---

1. For comprehensive information on federal investments in water resource projects and veterans health care facilities, see CBO, *Veterans Administration Health Care: Planning for Future Years* (April 1984), *The Federal Budget for Public Works Infrastructure* (July 1985), *Efficient Investments in Water Resources: Issues and Options* (August 1983), and *Current Cost-Sharing and Financing Policies for Federal and State Water Resources Development* (July 1983).

is already large enough to accommodate most of the hospital and nursing home needs of veterans with service-connected problems and those unable to defray the costs of care under a means test such as that used for food stamps or veterans' pensions. Moreover, a large funding cutback, proponents argue, would still allow new construction in some areas where top-priority needs cannot be accommodated within existing facilities. Advocates of less construction also point to the lower operating costs available if planning for nursing care relied more on the use of both community homes operated on a contract basis and homes operated by state agencies. (For related measures see NDD-31, NDD-32, and NDD-33.)

Opponents view a limitation on construction as eventually reducing health care alternatives for some nonservice-disabled veterans, who could be denied local access to tax-supported VA care. This problem, they hold, would become more acute as World War II veterans continue to age. Others point out that both the VA's medical school affiliations and the supply of reserve beds for military needs in time of war or national emergency might decline.

Postal Facilities. The annual level of new commitments for postal facilities has increased dramatically in recent years, rising from under $0.3 billion in 1981 to an estimated $0.7 billion for 1986. The Postal Service has scheduled a decline, with future commitments to drop to $0.6 billion by 1991. But some advocates believe an even lower level of future commitments may be wise, in the face of changing communications technology and continuing loss of business to private carriers. If subsidized postage for certain mailers were eliminated and use of the Postal Service diminished, less construction might eventually follow (see NDD-19).

Opponents believe that a mandated cut would take away independence granted by law to the Postal Service, hamper efficient delivery of service in some localities, and curtail continued gains in labor productivity. In addition, any resulting deficit reduction would be temporary, because postage rates, which are set at levels that cover expected construction and other requirements, would eventually be adjusted to reflect lower construction costs. In the near term, however, a cutback in new projects would improve the Postal Service's cash balances (because disbursements drop faster than depreciated costs incorporated in postage rates) and would thus lower the federal deficit.

NDD-05 REDUCE FUNDING FOR FOREIGN AID

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	1,416	1,601	1,661	1,725	1,794	8,198
Outlays	716	974	1,231	1,429	1,555	5,905

Aid from the United States to recipient foreign countries is composed of international security assistance and development aid. The two types of aid programs differ mainly in what purposes they serve and how they are justified to the Congress. Security assistance includes both economic and military aid intended to bolster nations of political and strategic importance to the United States. To do so, security assistance programs give general--and often unconditional--budgetary support (appropriated in the Economic Support Fund) for a wide range of economic policies, as well as grants and loans to finance purchases of U.S. military equipment and support services. Development assistance, in contrast, is intended to improve conditions for the world's poor and meet economic development needs. Aid in this category is provided through the World Bank and other multilateral regional development banks, and as bilateral development aid administered by the Agency for International Development and the P.L. 480 Food Aid program.

Between 1980 and 1986, outlays for foreign aid have grown from $8.4 billion to an estimated $14.2 billion. While development assistance has only kept pace with inflation, however, security assistance has experienced more than 5 percent real growth per year during that period. The upward trend in total foreign aid spending could be reversed by cutting all programs in nominal terms by 10 percent over the next five years. This would reduce outlays by $0.7 billion in 1987 and $5.9 billion over the next five years. In contrast, the President's budget recommends a cut of $0.8 billion in outlays for development assistance, but an increase of $2.2 billion in security assistance, yielding an increase in total foreign aid spending of $1.4 billion over the next five years.

Critics of foreign aid charge that, through the years, development assistance has gone through passing fads, from infrastructure development, to basic human needs, to economic restructuring; few efforts, they claim, have produced lasting benefit to the recipient countries. For example, some recipient countries that in the past had readily accepted development assistance to help fund large-scale projects are now questioning the long-run value of many such investments. Indeed, skeptics contend that economic aid is often counterproductive, simply postponing the development of markets, political institutions, and economic policies that are essential to economic progress. Moreover, since World Bank replenishments will be negotiated in 1987, multilateral development aid can be cut without the United States abrogating any binding agreements. Opponents of security assistance claim that U.S. foreign policy and national security objectives dominate the determination of funding allocations, in some cases causing the United States to subsidize failing economic policies. Loans for military sales have burdened some recipients, diverting foreign exchange into debt service.

Advocates of this aid, on the other hand, warn that the timing of the United States' budgetary deliberations do not coincide with military, political, and economic problems throughout the world. Basing foreign assistance on short-term budgetary needs could compel the United States to take much more costly measures over the long term. Others argue that development aid has played a vital role in improving, among other things, agricultural, health, and educational conditions in developing countries. The increasingly important role of the World Bank in encouraging developing countries to shift economic policies, highlighted by a recent U.S. initiative to augment the World Bank's role in ameliorating the international debt crisis, is also stated as a major justification of support to multilateral development institutions. Finally, opponents of a curb on foreign aid note that the U.S. contribution is already small. The United States contributes only 0.2 percent of gross national product, compared with an average of 0.5 percent of GNP for industrialized countries in general.

NDD-06 RECOVER THE ADMINISTRATIVE COSTS OF SELECTED REGULATORY AGENCIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
USDA	132	270	415	424	433	1,674
FDA	58	119	184	189	193	743
FCC	18	40	61	62	64	245
CFTC	9	18	27	28	29	111

The activities of many regulatory agencies benefit regulated industries as well as the general public. Many of these agencies are funded primarily from general revenues. In contrast, other regulatory agencies charge fees and assessments that raise enough income to meet or exceed the levels of their expenditures. Registration and filing fees for securities, for example, produce receipts that exceed the Securities and Exchange Commission's expenses. Similar cost recoveries could be applied to selected regulatory activities--specifically, those of the U.S. Department of Agriculture (USDA), the Food and Drug Administration (FDA), the Federal Communications Commission (FCC), and the Commodity Futures Trading Commission (CFTC). These activities provide specific benefits to identifiable recipients, who could be charged for these benefits in a cost-effective manner. The costs of regulatory activities that benefit only the general public--dissemination of information, for example--would be left unrecovered. For those areas in which cost recovery is considered, a three-year phase-in is analyzed.

When the USDA inspects the processing of meat, poultry, and other agricultural products, it provides a quality control system for the food industry free of charge. Recovering the full costs of the department's four food inspection services could save nearly $1.7 billion over five years. In its budgetary proposals for 1986 and 1987, the Administration proposed similar license and inspection fees, which would be paid by processors to the Treasury.

By assuring doctors and consumers of product quality, the FDA's regulation of drug safety and efficacy benefits the pharmaceutical industry. The costs of the FDA's drug regulation could be recovered from pharmaceutical companies, saving $743 million over five years. In 1985, the FDA itself proposed that the costs of new drug applications be recovered through fees, but this practice has not been implemented. The costs of other drug-related activities--manufacturing plant inspections, for example--could be recovered through a general assessment on pharmaceutical company sales.

The FCC could recover the costs it incurs in assigning licenses to mass media and private radio operators. These franchises are valuable, since they are awarded from a transmitting spectrum that is physically limited, yet they are awarded at no charge to applicants. The FCC spends a great deal of time and other resources on considering applications. Were licenses to be awarded instead by auction, administrative reviews might become unnecessary; this would lower costs. (The FCC has recently proposed a limited experiment with auctions.) In fact, revenue from bids for the government franchises could far exceed the FCC's current costs. Another cost-recovery approach could be to establish a broadcast fee that would capture a portion of the franchise value of existing mass media franchises. Cost recovery using either approach would be $245 million over five years. (This estimate does not include the common carrier costs of the FCC, which are already exceeded by telephone excise taxes.)

Finally, the CFTC supports public confidence in futures markets by regulating abusive trade practices. The Securities Exchange Commission (SEC) performs the same function for the securities markets, while recovering its full costs. If the cost recovery approach were applied to the regulation of commodity futures, $111 million could be saved over five years. Fees could be established for each futures contract, at an average cost per contract of about $0.16.

The clear public benefits these regulatory activities yield might justify financing from general revenues. In addition, many industries oppose regulation, claiming that it constrains profits by setting overly stringent requirements and by needlessly delaying market entry. Cost recovery would add insult to injury for industries that take this position. On the other hand, many of the regulatory activities cited here are carried out with the general support of the regulated industries. With budgetary constraints threatening to curb spending on regulation, a shift to user financing might assure the continuation of regulatory activities, or even permit an increase. An example might be new FDA user fees, which could speed the time it takes the FDA to process new drug applications. This would only be the case, however, if user fees were dedicated specifically to the agencies' accounts.

NDD-07 CHARGE STATE MEMBER BANKS AND BANK HOLDING COMPANIES FOR THE COSTS OF FEDERAL RESERVE SUPERVISION AND REGULATION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.2	0.2	0.2	0.2	0.3	1.1

Depository institutions--banks, savings and loan associations, and credit unions--bear costs and receive benefits from government policies. To carry out monetary policy more effectively, the Federal Reserve requires all depository institutions above a certain size to maintain reserve deposits with Federal Reserve Banks. Because no interest is paid on these deposits, this policy imposes costs on depository institutions. On the other hand, the tax code contains several preferences--allowing excess bad debt reserves, for example--that reduce the tax liabilities of depository institutions. In addition, the Federal Reserve's discount lending often carries an element of subsidy. This savings proposal does not directly address any of the costs and benefits from monetary and tax policies, but instead focuses on the supervision and regulation of depository institutions.

Five separate government agencies carry out the supervision and regulation of depository institutions. The Federal Reserve supervises and regulates bank holding companies, state-chartered banks that are members of the Federal Reserve System, and international banking corporations. The other depository institutions--nationally chartered banks, state-chartered banks that are not members of the Federal Reserve System, savings and loan associations, and credit unions--are supervised and regulated by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board with the Federal Savings and Loan Insurance Corporation, and the National Credit Union Administration. The latter four agencies cover all or nearly all of their administrative costs with fees received from depository institutions, as do all state banking agencies, but the Federal Reserve does not recover any of the costs of its supervisory and regulatory activities.

The complex structure of the federal government's banking supervision has often been criticized as needlessly elaborate, most recently by the Bush Commission in 1984. Savings could result over the long run by consolidating the activities of these agencies. In the near future, savings could be obtained by requiring the Federal Reserve to recover the costs of its supervisory and regulatory activities. The savings would be $1.13 billion over five years. (This estimate excludes the Federal Reserve's costs of monitoring reserve accounts.)

Supporters of this approach hold that effective supervision and regulation benefit the banking industry. Supervision serves banks by alerting management to potential problems with investments. It limits risk-taking by banks that hold their investors' and other banks' funds, and bolsters the confidence of consumers of banking services. Regulation restricts entry by potential competitors. Since all other depository institutions pay for these benefits, this savings proposal would simply extend a generally accepted practice to the banks served by the Federal Reserve. It might also provide an incentive to limit the growth rate of the Federal Reserve's supervision and regulation costs.

Not all of the Federal Reserve's regulatory activities, however, are of clear benefit to banks. Consumer protection regulations, for example, probably reduce bank profits. State member banks also argue that they should not have to pay for the costs of both state and national supervision. This implies that a federal purpose in supervision of state-chartered banks is not clear. Finally, the banks argue that, because they lose revenue from having to place a portion of their assets in non-interest-bearing reserves, they should not have to pay the costs of supervision. All other depository institutions maintain non-interest-bearing reserve deposits, however, and also cover the costs of supervision and regulation. The offsetting benefits from tax preferences and discount lending should also be considered in this calculation.

If cost recovery were adopted, assessments and fees could be set to reflect the Federal Reserve's actual costs. The Comptroller of the Currency, for example, charges assessments on a declining percentage scale of total assets, reflecting the scale economies in labor costs from examining larger banks. Flat fees are charged for merger, branching, and other application reviews. For the Federal Reserve to cover its costs, the assessment for a bank of median size would be about $90,000 in 1987.

Such savings are classified as a revenue gain because of the current accounting treatment of the Federal Reserve's administrative expenses.

The Federal Reserve earns roughly $18 billion a year in interest payments made on its portfolio, which consists primarily of Treasury securities. It deducts its administrative expenses from these profits and returns the balance to the Treasury. The Treasury classifies these payments as miscellaneous receipts on the revenue side of the budget. As a result, any reduction in the Federal Reserve's administrative expenses or any increase in its receipts would be scored as a revenue gain. 1/

---

1. See CBO, *The Budgetary Status of the Federal Reserve System* (February 1985).

NDD-08 RAISE AVIATION USER FEES TO COVER AIR TRAFFIC CONTROL COSTS COSTS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.4	0.5	0.6	0.7	0.7	2.9

Aviation user fees--most important, an 8 percent tax on domestic passenger tickets and fuel taxes for private aircraft--currently recover the capital costs of building and equipping air traffic control facilities and fund federal grants for airport improvement.[1] At present, however, these fees are not adequate to cover the federal government's costs of operating the air traffic control system. Charging aviation users for their total shares of these costs would raise an additional $400 million in 1987 and $2.9 billion over the 1987-1991 period.

General aviation users--firms and individuals that own and operate aircraft for business or personal use--pay only about one-tenth of their share of all federal aviation expenditures, while commercial aviation users overpay by about 20 percent. If general aviation fees were raised in 1987 to cover 40 percent of the costs these users impose and increased to 55 percent by 1990, the subsidy from the general taxpayer could be largely eliminated. Any increase beyond this level could be applied specifically to reducing the overpayment now coming from airline users through taxes on tickets.

General aviation user fees could be raised in several ways, including increasing fuel taxes, imposing a sales tax on the purchase of new small planes and equipment, or placing direct federal fees on general aviation. A large tax on fuel would place a severe and disproportionate burden on recreational flyers, who make little use of the federal air traffic control system. By contrast, a sales tax would target the much costlier corporate jets that are the heaviest private users of the system.

---

1. See CBO, *Charging for Federal Services* (December 1983) and *Financing U.S. Airports* (April 1984).

Charging direct federal fees (landing fees, for example) would have the advantage of making a more explicit link between the fee charged to each aircraft and the costs it imposes on the system. This approach would require resolving several issues, including jurisdictional questions, the administrative costs of collecting such fees compared with other aviation user fees, and the ability to identify air traffic control costs and allocate them accurately to individual users. The Federal Aviation Administration's ongoing program to replace and modernize air traffic control equipment should, over the next decade, ease these problems by making it technically feasible to identify all users of the system and thus to allocate costs more precisely. 2/

Though higher fees for general aviation would encourage more efficient use of the nation's airport and airway system, opponents argue that general aviation users should not be forced to pay their full share of costs for an air traffic control system that was designed to meet the needs of large commercial jets. Increased fees for general aviation would also reduce sales by the manufacturers of general aviation aircraft.

The Administration has no current proposal to increase general aviation fees.

---

2. See CBO, *Improving the Air Traffic Control System* (August 1983).

NDD-09 ESTABLISH USER FEES FOR CERTAIN COAST GUARD SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	820	830	830	840	860	4,180
Outlays	820	830	830	840	860	4,180

User fees could be established for U.S. Coast Guard services that provide direct benefits to commercial mariners and recreational boaters. These programs, totaling about $1 billion in annual federal spending, include aids to navigation, search-and-rescue activities, marine safety, and marine environmental protection. [1] In 1987, $820 million would be saved. Over the 1987-1991 period, full recovery of associated federal costs from mariners and boaters would yield $4.6 billion to offset Coast Guard outlays.

The Coast Guard provides substantial, uncompensated benefits to civilian navigation, especially to the commercial shipping industry. Without navigational aids, such as buoys and other channel markings, commercial shipping in U.S. inland and coastal waters would be considerably more difficult, hazardous, and costly than it is now. The capital and operating costs of these aids could be recovered from the shipping industry, just as highway users pay for the costs of roads. The Coast Guard also conducts search-and-rescue operations for lost or disabled vessels; about three-fourths of such activities assist recreational boaters. (Opponents of user financing for the Coast Guard's life-saving services see these as historical responsibilities of the federal government.) The costs of these services could be recovered through registration fees for recreational boats and other types of fees for commercial vessels. These Coast Guard services can be treated as comparable to emergency medical care and user fees to health insurance premiums.

User fees might, however, be difficult to collect from recreational boats, and they would increase costs for the currently depressed fishing industry. (If Coast Guard fees for fishing vessels were phased in over five years to avoid imposing too sudden a financial burden on this industry, the federal budgetary savings would be reduced by about $400 million for 1987 through 1991.)

---

[1] See CBO, *Charging for Federal Services* (April 1983).

The Administration proposes Coast Guard user fees of $240 million in 1987 and $480 million a year starting in 1988. Most of this sum would be collected as registration fees from all classes of boaters--the typical recreational boater would pay $20 per year, for example. A lower level of fees was called for by the 1986 budget resolution.

NDD-10 ELIMINATE CARGO PREFERENCE FOR NONMILITARY SHIPMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	500	550	600	600	600	2,850
Outlays	500	550	600	600	600	2,850

The federal government provides both indirect and direct subsidies to the U.S.-flag merchant marine--that is, vessels built, owned, and operated by U.S. firms and engaged in international trade. A major form of indirect aid is provided through so-called "cargo preference" legislation, which requires that all U.S. military cargo and one-half of other government freight be carried in U.S.-flag vessels. Most nonmilitary shipments consist of bulk cargo, including agricultural exports and shipments for the Strategic Petroleum Reserve (SPR). (See also NDD-02.) The Food Security Act of 1985 has just extended cargo preference to 75 percent of U.S. agricultural aid. Because the average costs to build and operate U.S. vessels are some two to three times those for non-U.S. ships, this guaranteed market increases government shipping costs substantially. Eliminating cargo preferences for nonmilitary shipments would reduce federal spending by about $500 million in 1987 and $2.85 billion over the 1987-1991 period.

Critics of the program believe that it raises government transportation costs unduly while subsidizing inefficient carriers. On the other side, the loss of nonmilitary government cargo would force some higher-cost U.S. vessels out of business, thus somewhat reducing the nation's military sealift capacity in an emergency. This effect would be minor, however, since bulk cargo vessels, which are the main beneficiaries of cargo preference, cannot easily be adapted for military sealift. Some of these vessels may have been built using federal loan guarantees. There is thus the possibility of loan defaults, which could offset these cargo preference savings for the first couple of years.

The Maritime Administration also provides U.S. shipping with direct assistance--more than $400 million in 1985--through subsidies that make up the difference between the operating costs of foreign and U.S. shipping.

(These operating subsidies are difficult to change, since they are provided under long-term contracts.) Some vessels receive subsidies under both the cargo preference and operating subsidy programs. As an alternative to changing cargo preference laws, this double subsidy could be eliminated, thus reducing the operating subsidy by perhaps $20 million a year and $125 million over the 1987-1991 period.

The Administration proposes to roll back the 75 percent cargo preference level to 50 percent. This would save an estimated $100 million in 1987 and $250 million in 1991. The Administration also calls for eliminating the double subsidy from the operating subsidy program.

NDD-11 REDUCE SUPPORT FOR INLAND WATERWAYS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	260	270	280	290	300	1,400
Outlays	250	260	270	280	290	1,350

In 1986, the Army Corps of Engineers will spend about $620 million on the maintenance, rehabilitation, and construction of the nation's system of inland waterways.[1] About $400 million goes to maintain and operate locks and canals, and $220 million goes toward construction projects approved more than 10 years ago. Current legislation before the Congress would authorize between $1.4 billion (S. 1567) and $2.6 billion (H.R. 6) in new construction projects--the first new authorizations in this area since 1974.

Fuel taxes of 4 cents a gallon were imposed on barge transport for the first time in 1981; they have since risen to 10 cents a gallon. Current legislation before the Congress would increase this tax to 20 cents per gallon over the next 10 years. Even so, receipts would not recover more than 15 percent of spending on the inland waterway system over the 1987-1991 period, leaving net five-year federal spending on the system at about $3.4 billion. Eliminating projects to enlarge the system's capacity while retaining only those programs needed to operate existing canals, locks, and dams would save $250 million in outlays in 1987 and $1.4 billion over the 1987-1991 period. (Alternatively, new excise taxes on the barge industry could be imposed to offset all federal spending on inland waterways, saving $3.4 billion over the next five years.)

Proponents of a cut in new construction argue that capital expansions are unnecessary. They cite as evidence the overcapacity in the barge industry--about half the fleet is now idle--as well as the unwillingness or inability of barge operators to pay for the projects through higher user fees. Proponents of user fees, however, argue that these tariffs would help ensure that the most cost-effective projects were built and would reduce any competitive advantage provided by federal aid.

---

[1] See CBO, *Charging for Federal Services* (December 1983).

A virtual elimination of capital spending by the Corps would force barge operators and shippers to undertake any capital improvements themselves, or to support higher user fees to finance Corps work. Opponents of such a proposal point to the difficulties inherent in private development of facilities used over large geographic areas by competing companies and firms. They argue that, should the industry rebound, there might be a delay in providing desirable capital improvements.

The Administration proposes to double the current 10-cent-per-gallon tax on barge fuel over the next 10 years, as called for under S. 1567. By 1997, this would generate about $50 million in additional user fees.

NDD-12 ELIMINATE FEDERAL MAINTENANCE ASSISTANCE FOR DEEP DRAFT PORTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	440	460	470	490	500	2,360
Outlays	430	450	460	480	500	2,320

The Army Corps of Engineers spends about $500 million a year to maintain channel depths at more than 200 ports nationwide. Port users (shippers) benefit directly from this program both through the savings from shipping in larger vessels and by being able to minimize inland transport costs.[1] Eliminating federal maintenance assistance would produce outlay savings of $430 million in 1987 and $2.3 billion over the 1987-1991 period.

At large ports, the dredging cost per ton of cargo amounts to only a few cents; at small ports, it is commonly in the hundreds and sometimes thousands of dollars per ton--well above any savings in transport costs and sometimes even exceeding the cargo's value. This "free" (Corps-provided) dredging diverts cargo from ports with natural deep water to ports that shippers would otherwise find too expensive to use. Forty-five ports with channels maintained by the Corps handle no cargo at all. Eliminating federal aid would force ports either to impose their own user fees or to seek nonfederal governmental subsidies. As a result, the role of the Corps could be limited to that of a paid dredging contractor (in competition with others). This would limit demand for the Corps' services to ports at which users pay and to depths consistent with port users' needs. Port operators would also have a clear incentive to undertake their own harbor improvements, rather than wait for the Corps to do the work.

Advocates of continuing the Corps' current role in maintaining ports argue that many small ports might forgo maintenance dredging or perhaps close entirely. This could result in social and economic dislocations.

---

[1] See CBO, *Charging for Federal Services* (December 1983), Chapter II.

Proponents of cutting this Corps' activity maintain that the overall efficiency of the nation's port system would be improved.

An alternative to the cost-cutting measure outlined above, S. 1567 now before the Congress calls for a 0.04 percent tax on the value of commercial cargo shipped through U.S. ports. Collections could total $1.2 billion through 1991, producing offsetting receipts equivalent to roughly one-half of projected federal spending. This proposal is also included in the Administration's proposed budget for 1987.

NDD-13 ELIMINATE AMTRAK SUBSIDIES

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	610	640	670	690	720	3,330
Outlays	610	570	630	690	720	3,220

Since its start in 1971, Amtrak has received $11 billion (in 1985 dollars) in federal subsidies for its intercity passenger services. When establishing Amtrak, the Congress thought only start-up costs would need to be federally subsidized.[1] On the contrary, subsidies have continued, and they now exceed $600 million a year, covering all capital spending and nearly one-half of operating costs. Amtrak riders received 17 cents per passenger mile in federal subsidies in 1985--more than the average cost per passenger mile of commercial air travel. In contrast, intercity bus passengers received a net federal subsidy of 0.2 cent per passenger mile, and commercial aviation and automobile travelers more than covered their estimated federal costs through payment of excise taxes on tickets and on fuel. Eliminating federal support for Amtrak would save $610 million in outlays in 1987 and $3.2 billion from 1987 through 1991.

Proponents of such a change argue that the current subsidy provides little incentive to recover costs--even on the potentially profitable Northeast Corridor. Cutting all subsidies for these lines could therefore be particularly effective. Further, raising fares on other lines would increase the possibility that competing bus or air services would become financially attractive to travelers, and would thus decrease the dependence of some small towns on Amtrak services.

Opponents claim that reduced federal support would lead Amtrak to cancel service where the demand is low but where reliable year-round services are not provided by other kinds of transport. They also believe that such cancellations would threaten the integrity of the national rail network. (The effect on the nation's overall passenger transport system would be

---

1. See CBO, *Federal Subsidies for Rail Passenger Service* (July 1982).

negligible.) Further, any cancellations could well involve employee protection benefit payments (including up to six years in salary), which would reduce the savings unless the Congress modified this provision.

Alternatively, Amtrak subsidies could be reduced and restructured to improve cost control and efficiency incentives while affording protection to towns that might otherwise be left without intercity transport. Savings could total $300 million in 1987 and $1.7 billion through 1991 by a combination of simultaneous actions: eliminating subsidies on the Northeast Corridor; requiring that fares (or local subsidies) for each route cover at least all costs for crews, supplies, and fuel; and cancelling subsidies for services to points that receive transport subsidies under small-community air service grants.

The Administration calls for the elimination of all federal aid to Amtrak, with no provision for any labor payments.

NDD-14 REDUCE FEDERAL MASS TRANSIT AID

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	1,790	1,840	1,890	1,900	1,920	9,340
Outlays	720	1,030	1,280	1,490	1,690	6,210

The federal government currently provides substantial assistance to mass transit through programs that support the capital and operating costs of most public transit systems. These programs, administered by the Urban Mass Transportation Administration, have grown dramatically since they were first instituted in the mid-1960s. Outlay savings of $720 million in 1987 and $6.2 billion over the 1987-1991 period could be obtained by reducing the federal match on capital grants from the current 75 percent or 80 percent to 50 percent, and by eliminating operating assistance.

Supporters of such a reduction note that federal aid has allowed transit systems to finance large increases in costs--real unit labor costs, for example, increased 43 percent during the 1970s--while ridership and fare collections declined. They also argue that the large federal subsidies for capital spending have encouraged local transit agencies to purchase new capital equipment, such as large buses and subways, rather than to improve the quality or productivity of existing services. Finally, they assert that reduced federal operating and capital support would force local authorities to lower costs and increase ridership by making greater use of innovative techniques. These could include private contracting for services, use of more cost-effective smaller vehicles to meet the needs of special groups, direct subsidies for low-income riders (akin to food stamps), and reduced local regulations to permit private firms to compete directly with public transit agencies.

Proponents of federal transit aid maintain that public transportation is essential to urban mobility and that sudden changes in financial assistance could cause dislocations and hardships for certain groups. Others argue that an across-the-board cut would be particularly inefficient, in that the greatest need for large investments in transit improvement is now mostly confined to rehabilitating systems in older cities and that federal assistance should be targeted toward such cities.

The Administration's budget calls for the elimination of all operating assistance and two-thirds of capital grants. The remaining capital grants ($1.1 billion) would be combined with about $2.2 billion in federal highway grants to form a new ground transportation block grant. At local discretion, these funds could be used for either transit or highway capital projects.

NDD-15 REDUCE AND REFOCUS HIGHWAY SPENDING

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	6,400	6,700	6,900	7,200	7,500	34,700
Outlays	900	3,800	4,700	5,200	5,600	20,300

The federal government, in partnership with the states, finances construction and repair of highways and bridges. Federal spending in 1985 totaled $12.8 billion--about one-third of total spending for highways and bridges. For 1986, the Congress has authorized an increase in highway spending to $15.3 billion. Over the years, the federal/state partnership in financing the construction of highways has grown to include more locally oriented segments of the nation's road network, such as beltways and other local routes. As a result, today only two-thirds of federal highway funds are spent for the two most nationally oriented road systems--the Interstate and Primary systems--compared with nine-tenths just 15 years ago. By limiting the federal highway program to its original emphasis on intercity arteries, the Congress could save $0.9 billion in 1987 and $20.3 billion through the 1987-1991 period.

At present, locally oriented routes account for almost two-thirds of the spending needed to complete the 1,200 miles still to be built on the Interstate system. Confining federal support to Interstate routes of national significance only would reduce outlays by $7 billion over the next five years alone. Turning financial responsibility over to state governments for urban and secondary roads, for other non-Interstate roads, and for local bridges would reduce federal spending by an additional $13.3 billion over the next five years.

Withdrawing federal support for such routes, however, would involve breaking long-standing commitments, and would force either substantially greater state and local expenditures or the curtailment of some construction and repair work. The added burden on states could be relieved somewhat by providing them with a portion of the revenues from the increase in the federal motor fuels tax enacted in 1982, but this would also reduce the federal budgetary savings.

Rather than being eliminated, the federal share of the costs of local routes could be reduced to 50 percent (from the present 90 percent for Interstate routes and 75 percent for other roads). This would encourage state highway departments to subject roadwork proposals to stiff tests of potential cost effectiveness. Some planned segments of the Interstate might be left unbuilt. Federal budgetary savings would total about $8.6 billion over the next five years, with more than one-half coming from the Interstate program.

Spending reductions from a more limited federal role in highways would save more than enough to cover the projected $6 billion shortfall in the Highway Trust Fund over the next five years. Instead of reducing aid, however, the Congress could correct this shortfall by increasing the current tax on motor fuel by 1 cent per gallon. About $4 billion in revenues could be generated from 1987 through 1991 by eliminating the motor fuel tax exemption for gasohol (equivalent to a subsidy of 60 cents per gallon), for state and local governments, and for local transit buses.

The Administration proposes holding highway spending to $12.8 billion, their estimate of highway excise tax receipts (but excluding any interest earned by the cash balance in the Highway Trust Fund). This represents a cut of about 5 percent from the current level of spending. The Administration also calls for the elimination of the tax exemption for gasohol and for private buses.

NDD-16 ELIMINATE FEDERAL SUPPORT TO STATES FOR CONSTRUCTION OF SEWAGE TREATMENT PLANTS

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	705	1,442	2,180	2,930	3,089	10,346
Outlays	5	93	393	890	1,486	2,867

The federal government provides grants to states and local governments to assist in the construction of local sewage treatment plants. Such plants are required to meet the stringent clean water goals mandated by the Federal Water Pollution Control Act Amendment of 1972.[1] Construction of local wastewater treatment plants is subsidized for two reasons. First, federal participation is deemed necessary to achieve the mandated national goal of clean water. To ensure local compliance with this expensive mandate, the Congress offers the incentive of large federal grants. Second, while sewage treatment plants help solve local water quality problems, they also provide cleaner water to downstream users, who are often outside the jurisdiction of the community that built the plant. Early attempts to combat water pollution demonstrated that few communities, if any, were willing to fund treatment facilities that solved more than local problems. Thus, another purpose of the capital subsidies is to compensate local taxpayers--who use and help build the plants--for providing benefits to other regions, benefits that might not ordinarily be captured. The government now provides 55 percent of planning, design, and construction funds for treatment plants; this share was lowered from 75 percent at the start of 1985.

Authorization for the Construction Grants program expired at the end of 1985, but current proposals call for continuing grants through 1990. Current baseline budget projections for these activities call for roughly $2.5 billion in appropriations in 1987, and a total of $13.9 billion over the 1987-1991 period. If grants for sewage plants were phased out over three years beginning in fiscal year 1987, the federal government could save about $5 million in outlays in 1987, and nearly $2.9 billion over the 1987-1991 period. This

---

1. See CBO, *Efficient Investments in Wastewater Treatment* (June 1985).

proposal is identical to the Administration's policy initiative for phasing out construction grants.

Critics of the sewage grant program contend that it fosters inefficiency by providing little incentive to seek cost-effective solutions. A community that expects to receive 55 cents on the dollar from federal funds (plus additional subsidies provided by many state treasuries) has less incentive to control plant costs than if it had to pay for the entire investment. Another common criticism is that the sewage grant program, begun 14 years ago, has long exceeded its original planned lifetime of only three years. Finally, the federal wastewater grant program has created a pattern in which facilities line up and wait for federal assistance, for periods of possibly 10 years or more. While communities wait for federal subsidies, their wastewater discharges violate clean water mandates, and the quality of streams and rivers shows little improvement.

By limiting funds to only those projects begun before 1987, the federal government could reduce budgetary outlays by more than $3.5 billion over the 1987-1991 period. As an alternative, the federal government could reduce outlays more slowly by gradually lowering the federal share to zero. (Some opponents contend that the federal matching share should be lowered to approximate more closely the benefits provided; however, others contend that if benefits are correctly estimated, the federal matching share should actually rise.)

In any case, curtailing federal subsidies would transfer a large cost burden to states and localities. In the Environmental Protection Agency's latest calculation, it estimated that remaining nationwide sewage plant construction needs would cost $109 billion by the year 2000, of which about $53 billion would be eligible for federal grants. To meet these needs without federal support, even by the year 2005, states and local jurisdictions would have to spend about $6 billion a year, or about twice current nonfederal outlays.

NDD-17 REDUCE CREDIT SUBSIDIES TO FEDERAL POWER MARKETING ADMINISTRATIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	88	259	236	211	193	987
Outlays	144	569	504	433	368	2,018

Federal power marketing administrations--including the Bonneville Power Administration, the Southeastern Power Administration, the Southwestern Power Administration, and the Western Area Power Administration--sell electricity at wholesale rates from generating plants owned and operated by the federal government. Capital investments for these generation facilities are financed by federal appropriations at subsidized interest rates averaging 3 percent. By law, the agencies are required to use income from electricity sales to repay all federal investments within a "reasonable period," though not at a set rate or on a fixed timetable. Because Treasury repayments are the first to be deferred when revenues are insufficient to meet all obligations, however, some power marketing administrations have fallen behind on planned repayment to the U.S. Treasury. Moreover, because subsidized rates are lower than actual government borrowing costs, the Treasury has lost money through its appropriations to the power marketing administrations.

The Bonneville Power Administration, for example, has deferred repayments of its appropriations over the last decade. To date, it has reimbursed the Treasury only $0.6 billion of the $6.4 billion appropriated for power purposes. Its cumulative repayments would have been about $1.2 billion more since 1974, had it adhered to a fixed repayment schedule. If all federal investments had been repaid at the Treasury interest rate, the Bonneville Power Administration's interest payments would have been $2.8 billion greater over the 1974-1984 period.

Requiring the power marketing administrations to repay all federal appropriations on a fixed schedule and at current Treasury interest rates (about 6.6 percent for one-year notes by 1990) would increase Treasury revenues, and would thus lower federal outlays by $144 million in 1987 and about $2 billion over the 1987-1991 period. These changes could increase electricity rates for wholesale customers in certain agency service areas. As an alternative--to reduce the effects of a potential price shock on households and industrial customers--the currently subsidized interest rates charged to the power marketing administrations could be gradually raised to current Treasury rates. This would slow the pace at which agency repayments increased.

In contrast, the Administration proposes to sell (privatize) all transmission and power generating facilities of the power marketing administrations. Assuming that all power agencies can sell their facilities under the Administration's criteria, outlay savings over the 1987-1991 period could reach $11 billion, relative to the baseline projections.

Though the power marketing administrations have promoted regional industrial bases by providing electricity to undeveloped areas, critics contend that the electricity prices charged today by the various agencies do not reflect the actual cost of delivering power. They point out that the original goal has been met, and that the below-market rates simply represent an inequitable subsidy to certain regions--a cost borne by all taxpayers. Finally, they argue that withdrawing the subsidy from power agency interest payments would not disrupt local economic activity, since electricity prices in areas served by the power agencies would still remain low relative to the national average (they now are less than one-half of the national average). Proponents of the status quo counter that withdrawal of the subsidy could, for some industries, translate into higher product prices and lost market shares.

NDD-18 END THE EXPORT-IMPORT BANK DIRECT LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	400	800	0	0	0	1,200
Outlays	200	400	500	500	500	1,900

The Export-Import Bank (Eximbank) attempts to increase U.S. exports by providing loans and loan guarantees to foreign purchasers of U.S. merchandise. The direct loan program offers subsidized interest rates, while the loan guarantee program encourages commercial banks to extend credit to foreign buyers by reducing the risk inherent in export financing. Between 1981 and 1985, the level of new direct loans by Eximbank fell from $5.4 billion to $0.7 billion. Eximbank responded in fiscal year 1986 by offering loans with subsidies over 25 percent and increasing the amount of a sale the bank would finance from 65 percent to 85 percent of the total export value. For 1987, the President is proposing to finance $1.8 billion of direct loans through Eximbank guaranteed borrowing from the public instead of through the Treasury. This change in the means of financing would raise government costs, because of the greater expense of circumventing the customary federal financing mechanisms. Annual Eximbank loans are projected to increase from $1.1 billion in 1987 to $1.3 billion in 1991. Eliminating the direct loan fund would save $200 million in outlays in 1987 and $1.9 billion over the five-year period.

Advocates of these loans base their position on three arguments. First, these loans are needed to offset the subsidies other nations provide for their exports. Second, increased exports boost U.S. employment. Third, exports allow some U.S. high-technology industries to maintain a high level of output and, consequently, reduce costs through economies of scale.

Critics of Eximbank's direct loan program consider these justifications overstated. In many instances, the exports in question face little if any subsidized competition, either because U.S. firms have monopolies or near-monopolies in certain submarkets (such as long-range aircraft with 250-plus seats), or because no other nations provide subsidies to the product in question. Furthermore, using Eximbank loans to escalate subsidy levels is not necessarily a useful strategy: other nations may choose to match U.S. subsidies. If all nations chose to follow the U.S. example, all nations would be subsidizing prospective purchasers, and no nation would be better off. Furthermore, evidence suggesting that the loans encourage new exports is scarce. Rather, these loans often represent new financing of exports that would have been purchased without federal involvement. Where this occurs, these loans represent not new jobs but windfall transfers of income from U.S. taxpayers to domestic producers and foreign purchasers.

NDD-19 DISCONTINUE POSTAL SUBSIDIES FOR NOT-FOR-PROFIT ORGANIZATIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	490	530	550	570	610	2,750
Outlays	490	530	550	570	610	2,750

The Postal Reorganization Act of 1970, which replaced the old Post Office Department with the current U.S. Postal Service, intended that the mail system operate as a largely self-sufficient enterprise with mail users paying the full costs of postal services. But certain bulk mailers--notably educational, religious, and other not-for-profit organizations--receive favored statutory treatment. These favored mailers pay reduced postage rates that cover less than the full cost of the services they receive. 1/ The taxpayer subsidizes the remaining cost through annual payments from the Congress referred to as revenue forgone appropriations. In 1985, the revenue forgone payment for not-for-profit bulk mailers totaled nearly $650 million. Almost $2.8 billion could be saved through 1991 if such payments were discontinued and postage rates were increased accordingly. Smaller subsidies supporting reduced rates for blind and otherwise handicapped persons, libraries, and others could be continued.

The subsidy was originally intended to promote the flow of educational, cultural, charitable, and other similar information. It also reflected an effort to ease the transition from the old, heavily subsidized post office system to the new self-supporting Postal Service. Eliminating postal subsidies would, on average, cause rates for not-for-profit organizations to double or more. Such rate hikes could pose financial difficulties for some organizations, especially those that depend heavily on mail solicitation for fund-raising and those just starting out.

Cutting the revenue forgone appropriation would be consistent with the President's 1987 budget. Critics of the subsidy argue that discontinuing reduced postage rates would further the goal of a self-sufficient postal

---

1. See CBO, *Charging for Federal Services* (December 1983), pp. 77-84.

service. Providing special rates for favored mailers, they contend, encourages overuse of mail services. This overuse, among other things, causes households to receive more mail than they may want; the Philanthropic Advisory Service, a branch of the Better Business Bureau that monitors the activities of charitable organizations, reports frequent complaints from citizens who have received multiple solicitations for support from the same not-for-profit groups. Further, the Advisory Service has found that, for many not-for-profit organizations--including a number of well-established groups--mail solicitation costs consume a very high percentage of related contributions. This suggests inefficient use of direct mail solicitation.

While acknowledging that discontinuing special rates could cause financial problems for some groups, critics of the subsidy argue that the government can no longer afford to support the mailing costs of groups already receiving substantial federal assistance. They point out that not-for-profit organizations received about $3.1 billion in federal grants in 1985, and that support in the form of tax deductions for charitable contributions will total an estimated $13.6 billion for 1986. Moreover, reduced postage represents an additional burden on taxpayers who, on their own, contributed more than $60 billion to charitable organizations in 1984. (Other deficit reduction measures affecting the U.S. Postal Service include NDD-04 and PERS-05.)

NDD-20 END FUNDING FOR THE LEGAL SERVICES CORPORATION

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	310	330	350	370	390	1,750
Outlays	270	320	340	370	390	1,690

The Legal Services Corporation (LSC)--an independent, not-for-profit organization established in 1974 legislation--provides free legal assistance to the poor in civil matters. Despite repeated attempts by the Administration to abolish the program, the Congress has continued to fund it. Termination of the LSC would generate five-year outlay savings of about $1.7 billion through 1991. This action would be consistent with the President's proposed budget for 1987. In contrast, cuts under the Balanced Budget Act would probably result in a simple reduction in program activity.

From its inception, the LSC has been the subject of much controversy. Critics have charged that the activities of legal aid lawyers too often focus on the advancement of social causes rather than on the needs of poor people with routine legal problems. The Administration and opponents believe that the responsibility for legal assistance to the poor should rest not with the federal government but with states and localities. From this perspective, support from other federal grants, private sources, and donated services could help to meet local needs for legal aid. Such an approach, critics argue, would give localities more control over legal aid programs, and would thus permit services to be more responsive to local needs.

Advocates of continuing the LSC argue that a specifically targeted federal assistance program is the only way to ensure that legal aid is available to people who cannot pay. They point out that the inadequacy of local and private resources was one of the factors that led to direct federal financing in the first place, and they believe that a strong federal program provides essential oversight and national direction. In response to the continued criticism that LSC lawyers act too often as social activists, proponents of the program point out that restrictions passed by the Congress over the years have already curtailed the activities some observers found objectionable.

NDD-21 ELIMINATE NEW LENDING OR INCREASE HOMEOWNERS' PAYMENTS UNDER RURAL HOUSING LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Eliminate New Lending						
Budget Authority	1,050	1,250	1,200	1,100	1,050	5,650
Outlays	1,000	1,200	1,200	1,200	1,200	5,800
Increase Homeowners' Payments						
Budget Authority	-15	-35	95	95	85	230
Outlays	35	75	120	160	210	600

The Section 502 housing program, administered by the Farmers Home Administration (FmHA), currently provides mortgages at effective interest rates as low as 1 percent to enable low-income borrowers to purchase homes while spending only 20 percent of their incomes on mortgage payments, property taxes, and insurance. The FmHA's major cost is the difference between the rates it pays for the funds it borrows to finance the program and the rates borrowers pay for FmHA mortgages. During 1985, over 40,000 rural households purchased single-family homes with reduced-interest-rate loans from the FmHA. Two approaches for reducing federal costs under this program are described here.

Eliminate New Lending. If new lending under the Section 502 program were eliminated, no new households would receive the deep subsidies that are now provided to only a small proportion of all eligible households. Some critics argue that a program that makes such sizable payments to so few households is not the best use of scarce federal resources. On the other hand, this approach would do away with a major tool that has enabled some low-income rural households to become homeowners. Ending new lending would reduce federal outlays by about $1.0 billion in 1987 and $5.8 billion in the 1987-1991 period.

Increase Borrowers' Payments. This alternative would continue lending at the present volume, but raise the costs to new borrowers. If, beginning in

1987, new FmHA borrowers paid 28 percent of their incomes for housing costs--the rate now charged under a comparable Department of Housing and Urban Development (HUD) program--federal outlays would be cut by $35 million in 1987 and $0.6 billion over the next five years. Thus, this option would eliminate a disparity between the HUD and the FmHA programs and scale back the size of the subsidy that is provided to only a small proportion of all eligible households. On the other hand, increasing the percentage of income that rural households would pay toward housing costs could shift the composition of borrowers away from the very lowest-income households, who might not apply for Section 502 loans if they felt that their monthly incomes could not support both higher loan payments and other living expenses. In addition, such higher housing costs relative to income might lead to higher default rates among new program participants.

The Administration's budget proposes to terminate this program in 1987 and to rely exclusively on rental assistance provided by HUD.

NDD-22 IMPOSE A ONE-YEAR MORATORIUM ON NEW FUNDING FOR THE RURAL RENTAL ASSISTANCE PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	55	30	-15	-20	-60	-10
Outlays	50	390	120	30	-20	570

The Section 515 program, administered by the Farmers Home Administration (FmHA), currently provides developers of multifamily rental projects in rural areas with 50-year mortgages with interest credits that reduce their effective interest rates to 1 percent. These reduced-rate mortgages in turn lower rental costs for Section 515 tenants, who are a small proportion of all eligible households in rural areas. Under current rules, assisted tenants contribute toward their housing expenses the greater of 30 percent of their adjusted incomes or the minimum project rent, which includes the costs of amortizing the 1 percent mortgage plus project operating expenses. The developer keeps the minimum rent, and the FmHA collects any payments above this minimum and treats them as additional interest payments to reduce total program costs. During 1985, about $900 million in new Section 515 loans were made, sufficient to finance about 25,700 new rental units.

A moratorium on new lending under this program would eliminate for one year the deep subsidies currently provided to developers of rural rental projects and to their tenants. Such a moratorium on the construction of new projects would reduce federal outlays by about $50 million in 1987 and $570 million in the 1987-1991 period, while precluding the provision of rental units for about 19,000 households.

Under the Section 515 program, the average annual subsidy for newly assisted households exceeds $2,000. Some critics argue that making such sizable payments to so few tenants is not the best use of scarce federal resources in times of budgetary stringency. On the other hand, imposing a moratorium on new funding under the Section 515 program even for a year would probably lessen the supply of standard-quality low-income rental projects in rural areas.

The Administration's budget would terminate this program in 1987 and provide rural rental assistance through housing vouchers administered by the Department of Housing and Urban Development.

NDD-23 REDUCE SUBSIDIES FOR LOW-INCOME ASSISTED HOUSING

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Moratorium on Additional Commitments						
Budget Authority	7,700	0	0	0	0	7,700
Outlays	160	460	690	850	930	3,100
One-Year Freeze of Rents						
Budget Authority	200	210	220	230	240	1,100
Outlays	290	310	350	390	420	1,750

NOTE: The savings estimate for the moratorium includes savings from rescission of balances of 1986 appropriations unobligated as of June 1, 1986. The savings estimates from the two options are not additive. Adoption of both would generate lower total savings than the sum of the two parts.

Each year, the federal government makes new 5- to 30-year commitments under the Section 8 and public housing programs to provide rent subsidies for an additional number of low-income households, augmenting those already receiving aid. The amount of additional assistance is determined by the Congress. By the end of fiscal year 1985, about 4.2 million subsidy commitments were outstanding for all rental programs combined, and about 3.7 million households actually received rental aid. Outlays for all assisted rental housing under these programs totaled $9.7 billion by the end of 1985. Even if no net additional commitments are made after 1986, expenditures will rise to over $12.5 billion by 1991. This increase takes place because some outstanding commitments have not yet resulted in households actually being assisted and because subsidies per household increase annually as a result of inflation in rents. If new commitments are funded in 1987 and thereafter at the same rate as is assumed in CBO's baseline projection for 1986, the total number of assistance commitments would grow by over 500,000 through 1991, and outlays would increase to almost $14.5 billion.

Moratorium on Additional Commitments. Appreciable savings could be realized by halting all commitments to assist additional households between

June 1, 1986, and the end of fiscal year 1987, while keeping the level of funding for modernizing decaying public housing projects constant. Thus, all 1986 unobligated balances would be rescinded, except for modernization funds, and no new budget authority would be needed for these programs in 1987. This option would generate reductions in outlays of $160 million in 1987 and $3.1 billion over the 1987-1991 period, relative to the baseline, with additional savings continuing to accrue for up to 25 years more, when all contracts associated with 1986 and 1987 budget authority would have expired. Greater savings could be realized if the moratorium were extended for more than one year.

Proponents of this option argue that expansion of rental assistance programs would be inappropriate at present in the light of cutbacks in other areas. They further note that the total number of income-eligible households served by rental assistance programs would continue to grow anyway, even during the pause in program expansion, because of commitments that have already been funded but have not yet resulted in occupied units. Others contend, however, that annual net increments in assisted rental housing have already been decreased sharply during this decade--from around 188,000 in 1980 to 99,000 in 1986--and that fewer than 35 percent of all eligible households are served by current programs.

One-Year Freeze of Rents. The Section 8 rental assistance program for existing housing, administered by the Department of Housing and Urban Development (HUD), aids renters by paying to the landlord the difference between 30 percent of the tenant's adjusted income and the unit's rent. Recipients of Section 8 existing-housing certificates must occupy units whose initial rents are at or below Fair Market Rents (FMRs) established by HUD. Under current Section 8 policy, FMRs as well as rents for units that are already subsidized are changed annually to reflect rental inflation. In contrast, under a recently enacted voucher program, HUD pays the landlord the difference between 30 percent of the tenant's income and the voucher payment standard--roughly equivalent to the FMR. Thus, voucher recipients are allowed to occupy units with rents above the voucher payment standard, provided that they pay the difference. The voucher payment standard for new commitments is adjusted annually, while the standard for outstanding commitments is adjusted at most twice during the five-year contract period.

Freezing FMRs, rents for units that are already subsidized, and voucher payment standards for one year at the 1986 levels would save $290 million in 1987. If no catch-up adjustments were made in 1988, savings would total $1.7 billion over the five-year period, with additional savings in subsidy payments continuing over the lives of the contracts.

Proponents of this option point out that it would spread the impact of the federal spending reduction across all current and new participants in these programs, whereas the moratorium would target all the loss toward potential new participants. On the other hand, this option would generate a variety of problems for certain subgroups of assisted households. In the Section 8 existing-housing program, unless landlords absorbed the decrease in real rents, some households with certificates issued in 1987 and beyond might be unable to find units within the rent guidelines. In addition, households that had been participating in the program might face a decrease in the level of services provided by the landlord, or, if their landlords dropped out of the program, a choice between moving to a new unit or losing their subsidy. A freeze on the voucher payment standard would not necessarily limit the number of units available to voucher recipients, but it might force some households to pay more than 30 percent of their income for housing.

The Administration's budget for assisted housing proposes no new funding for 1987; a freeze on FMRs, unit rents, and voucher payment standards; and substantial rescissions of unobligated 1986 balances. Moreover, it would fund roughly the same number of additional households with the remaining 1986 budget authority, by converting from long-term contracts to five-year vouchers. Thus, outlay savings over the 1987-1991 period would be lower under the Administration's proposal than under the first option described above.

NDD-24 ELIMINATE OR RESTRICT ELIGIBILITY FOR COMMUNITY DEVELOPMENT BLOCK GRANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Terminate CDBG						
Budget Authority	2,650	3,300	3,400	3,550	3,700	16,600
Outlays	50	1,050	2,650	3,300	3,450	10,450
Restrict Eligibility and Reduce Funding						
Budget Authority	430	450	470	490	510	2,350
Outlays	10	170	410	460	480	1,500

The Community Development Block Grant (CDBG) program provides annual grants, by formula, to all metropolitan cities and urban counties under its entitlement component. The program also allocates funds to each state, by formula, for competitive distribution among nonentitlement areas, which are generally units of local government under 50,000 in population that are not metropolitan cities or part of an urban county. The grants may be used for a wide range of community development activities, including housing rehabilitation, infrastructure improvements, and economic development.

For 1986, postsequestration appropriations for the CDBG program amount to almost $3 billion, of which the Administration proposes to defer $500 million to 1987. Of the remaining funds, $1.7 billion is allocated to metropolitan cities and urban counties and $0.7 billion to nonentitlement government units. Substantial federal savings could be realized in two ways: by terminating the CDBG program; or by both restricting eligibility for the entitlement component to exclude the least needy communities and reducing funding levels.

Terminate CDBG. If the CDBG program were eliminated entirely, federal outlay savings would amount to $50 million in 1987 and a total of $10.5 billion over the 1987-1991 period. Proponents of terminating the program contend that federal funds should be targeted to programs whose benefits are national in nature rather than to programs such as CDBG that generate primarily local benefits and should be funded by state and local governments. They further suggest that, to the extent that localities use CDBG funds to compete against each other to attract business, benefits have been shifted away from localities to firms.

On the other hand, opponents contend that many activities financed by CDBG are functions not generally undertaken by local governments--particularly the rehabilitation of low-income housing and, to some extent, economic development. Thus, eliminating this funding--the largest source of federal aid that many cities receive--would probably curtail these types of activities in many areas, and, in general, reduce resources benefiting low-income households. They further argue that CDBG has been figured into the budgets of all entitlement recipients, and ending that support could impose at least temporary stress on many governments, particularly in view of cutbacks in other federal assistance programs.

Restrict Eligibility and Reduce Funding for Entitlement Component. If the entitlement component were cut 20 percent by eliminating funding for the least needy communities, federal outlays could be reduced by $10 million in 1987 and $1.5 billion over the 1987-1991 period. Such a cutback would effectively change the distribution between the entitlement and nonentitlement components from 70 percent-30 percent to 65 percent-35 percent. The entitlement component of the CDBG program now provides aid regardless of need, although jurisdictions with scarce resources receive larger grants than other communities. Proponents of this option contend that no pressing interest is served by supporting jurisdictions that have above-average capacity to fund projects themselves. Eliminating funding for such communities rather than reducing grants across the board would ensure that the most distressed jurisdictions would retain the same level of aid.

On the other hand, CDBG funds in general must be used to aid low- and moderate-income households, to eliminate slums and blight, or to meet emergency needs. Thus, critics of this option argue that a reduction in federal funds for affluent communities would probably curtail such activities in pockets of poverty in those areas. The merit of such an argument would depend, among other things, on the share of funds affluent communities are now devoting to these types of activities.

The Administration's budget calls for a cutback in 1987 CDBG funding that is 18 percent greater than the cutback suggested in the second option described above. Moreover, the Administration's budget proposes changes in the allocation of funds that are similar to those outlined in the second option, but it does not call for elimination of funding for the least needy communities.

NDD-25 END FUNDING OF THE ECONOMIC DEVELOPMENT ADMINISTRATION AND URBAN DEVELOPMENT ACTION GRANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Terminate EDA						
Budget Authority	130	220	230	240	250	1,100
Outlays	30	90	150	200	220	690
Terminate UDAG						
Budget Authority	330	350	360	380	390	1,800
Outlays	20	110	210	280	340	970

NOTE: The savings estimates include savings from rescissions of fiscal year 1986 balances unobligated as of June 1, 1986.

The Economic Development Administration (EDA) provides grants to state and local governments for public works, technical assistance, and job programs, as well as loan guarantees and direct loans to firms for business development. In 1986, postsequestration appropriations for EDA programs totaled $176 million. For the Urban Development Action Grant (UDAG) program, administered by the Department of Housing and Urban Development, $316 million was appropriated (postsequestration) for 1986 for distribution to local governments through a competitive selection process. These governments use the funds, along with other resources, to finance economic revitalization projects. Federal spending for local economic development could be reduced by $50 million in 1987 and $1.66 billion over the 1987-1991 period by rescinding all EDA and UDAG 1986 budget authority unobligated as of June 1, 1986, coupled with disbanding the EDA and eliminating the UDAG program as of 1987.

Some critics of these programs contend that federal assistance should not be provided for activities whose benefits are local in nature and which, therefore, should be the responsibility of state and local governments. In addition, both programs have been criticized for the types of projects that they fund, for allowing federal dollars to be used for projects that would have been supported anyway, for not directing funds to the most distressed areas, for substituting public for private credit, and for facilitating relocation of businesses from one distressed area to another through competition among communities for federal funds. In particular, EDA has been criticized for its eligibility criteria, which qualify areas containing 80 percent of the U.S. population, and for providing aid with little proven effect at great expense compared with other programs with similar goals. While the UDAG program has more stringent eligibility standards and more evidence exists that completed projects are meeting investment and employment expectations, grants are often provided for projects in vital commercial centers where full conventional financing may have been available. Proponents of this option further argue that, because of the competitive nature of both programs, local governments would not have incorporated this type of aid into their budget plans, and thus, rescinding a portion of 1986 budget authority and eliminating future funding of EDA and UDAG would not impose unexpected hardships on communities.

On the other hand, the reduction in aid associated with this option would curtail economic development activities in some financially distressed communities that might not be able to tap other resources. This could result in deterioration of infrastructure, loss of prospective jobs, and decreases in local tax receipts. The elimination of these two sources of funds might have especially serious consequences for the most distressed communities, particularly in view of overall federal cutbacks in urban aid programs.

The Administration's budget proposes to terminate the EDA and UDAG programs and to rescind unobligated 1986 balances.

NDD-26 ELIMINATE FUNDING FOR UNTARGETED ELEMENTARY AND SECONDARY EDUCATION PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Eliminate Chapter 2 Block Grant						
Budget Authority	540	570	600	640	680	3,000
Outlays	45	410	560	600	630	2,250
Eliminate Untargeted Portion of Vocational Education						
Budget Authority	400	420	450	470	500	2,250
Outlays	10	320	420	440	470	1,650
Eliminate Mathematics and Science Education						
Budget Authority	45	50	50	55	60	260
Outlays	5	30	45	50	55	190

Most federal aid for elementary and secondary education is targeted toward students with special needs. Compensatory education (Chapter 1) funds, for example, are intended for low-achieving children in schools with many poor children. (Chapter 1 is part of the Education Consolidation and Improvement Act, or ECIA.) Federal funds also are provided to help educate handicapped children.

Substantial amounts of money, however, are spent on programs that are not targeted--in terms of federal requirements--toward students with special needs. Examples are the Chapter 2 block grant (of the ECIA), a portion of vocational education grants, and the mathematics and science education program. Ending funding for these three areas would reduce budget authority by about $1 billion in 1987--$540 million from the block grant, $400 million from the untargeted portion of vocational education, and $45 million from the mathematics and science program. Outlays would be reduced by $60 million in 1987 and $4.1 billion over the 1987-1991 period.

These changes would save substantial amounts of federal money while leaving intact federal aid specifically directed to students and school districts most in need of that assistance. Their effects on total spending for elementary and secondary education would also be small, for the reductions would constitute substantially less than 1 percent of total state, local, and federal expenditures. Moreover, since an unknown portion of these grants is used to support activities that districts would undertake even in their absence, elimination of the grants would affect the specific activities ostensibly funded by them less than the size of the grant might suggest.

On the other hand, this reduction could pose hardships for some jurisdictions, because it would come at a time of increasing enrollments. Moreover, these programs have purposes other than increasing services to students with special needs. For example, Chapter 2 block grant funds are intended to provide districts with relatively unrestricted funds for program innovations and improvements, and the goals of the program innovation portion of the vocational education program include helping districts alter their training programs as the skills needed for employment change. Terminating federal funds would require districts to rely on state and local resources for these purposes, and to the extent that the grants lead jurisdictions to provide services that they otherwise would not, these goals would be less well met as a result.

The Administration's budget proposes similar reductions in vocational education and elimination of the mathematics and science education program (the latter to be replaced by a new program of support for teacher training). The budget, however, proposes maintaining funding for the block grant at the 1986 presequestration level of $500 million.

NDD-27 INCREASE PELL GRANT TARGETING

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	360	380	410	430	460	2,050
Outlays	75	360	390	410	440	1,650

The Pell Grant program, which is the federal student aid program most focused on low-income students, provides grants to undergraduate students who attend school at least half time. The CBO estimates that fiscal year 1986 funding will support grants for almost 2.6 million students in the 1986-1987 school year. Grants will range between $200 and $2,100, averaging an estimated $1,300 per student. The CBO estimates that about 45 percent of this aid will go to dependent students--virtually all to students from families with incomes below $30,000, and 80 percent to students from families with incomes below $15,000. Students who are financially independent of their parents will receive the other 55 percent of the aid. Reducing federal funding for Pell Grants by 10 percent would lower federal budget authority by $2.1 billion during the 1987-1991 period.

This option could be implemented by simply cutting federal appropriations, or the cut could be combined with changes in the rules determining Pell Grant eligibility and awards. The number and types of students affected would depend on how the cuts were structured and on how institutions reacted to the reductions. If the current program rules were extended and the appropriation were reduced, the Secretary of Education could lower student awards so that estimated program costs would equal the level of appropriated funding. Although the Secretary has discretion on the particular formula used to reduce grants, he must use one that would protect the grants of the neediest recipients. Alternatively, the Congress could change the method of determining student eligibility. Options available to the Congress that would reduce aid for higher-income Pell Grant recipients while protecting awards for needier students include raising the minimum award, making the test for financial independence more stringent, and increasing the proportion of income that families would be expected to contribute to educational costs.

The possible changes discussed above would reduce federal costs while protecting the awards of the most needy recipients. By lowering or eliminating the grants of less needy students, such changes are unlikely to affect students' enrollment decisions. In addition, some colleges and universities would increase their support for student aid, thereby partially offsetting reductions in federal funding. Institutional responses would vary across types of institutions, however, with some colleges and universities continuing their current levels of student aid. Furthermore, the students who would lose aid under this option would generally have lower family incomes than many students who now receive other types of federal aid and would continue to do so, if the other student aid programs were unchanged.

The Administration's proposal would reduce Pell Grant funding substantially more than this cutback. Compared with the current program, the proposal would target aid more heavily toward lower-income recipients by, among other things, increasing expected family contributions to educational costs and making the test for financial independence more stringent.

NDD-28 REDUCE CAMPUS-BASED STUDENT AID

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	240	260	270	290	310	1,350
Outlays	25	240	260	270	290	1,100

The federal government provides campus-based student aid through three programs: College Work-Study (CW-S), National Direct Student Loans (NDSLs), and Supplemental Educational Opportunity Grants (SEOGs). Financial aid administrators at colleges and universities distribute these funds among eligible students. In the 1984-1985 school year, the federal government provided more than $1 billion of campus-based aid to more than 1 million students. Reducing federal funding for these programs by 20 percent would lower budget authority by $1.35 billion during the 1987-1991 period.

This option could be implemented by simply cutting federal appropriations, or the cut could be combined with a restructuring of the campus-based programs. The number and types of students affected would depend on how the cuts were structured and on how institutions and financial aid administrators reacted to the changes. Some institutions would continue their own student aid at existing funding levels, thereby having less financial aid available for students; other institutions might increase their own aid to offset part or all of the reductions in federal support.

Combining reduced funding with a restructuring of the campus-based programs could mitigate the effects of less aid. For example, the Congress could limit student eligibility. Because campus-based aid is not heavily targeted toward the lowest-income students, such changes would limit the adverse impact on the poorer students. On the other hand, such restrictions would reduce institutional discretion to adjust for students' special circumstances. A second option would consolidate the three campus-based programs into one block grant, thereby increasing administrators' discretion in allocating funds. Such an increase in discretion would probably not offset fully the effects of reduced funding, however, and could mean that federal goals were less well met. A third alternative would require institutions to provide a larger match of their own funds for each dollar received from the federal government. If institutions provided the increased match by raising their own support for student aid, the total amount of campus-based aid would continue at current levels, but some institutions probably would not do so.

The Administration's proposal would reduce funding for campus-based aid substantially more than this cutback. The proposal would combine the CW-S and SEOG programs, raise the institutional match for the consolidated program, and alter the NDSL program by increasing students' interest rates and by requiring income-contingent repayments.

NDD-29 REDUCE FUNDING FOR THE JOB TRAINING PARTNERSHIP ACT

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	420	590	770	960	1,170	3,910
Outlays	220	390	550	730	930	2,820

Titles II-A, II-B, and III of the Job Training Partnership Act of 1982 (JTPA) authorize grants to states to provide training services for economically disadvantaged individuals, summer jobs for disadvantaged youth, and employment and training assistance for dislocated workers, respectively. About $2.5 billion has been appropriated for grants for the program year that begins in July 1986. (An additional $800 million was appropriated for the Job Corps and other federally administered JTPA programs.) Rescinding 10 percent of 1986 budget authority for the JTPA grants to states and freezing the annual appropriation at the new level for the next five years would save about $2.8 billion in outlays over the 1987-1991 period. States could adjust by providing their own funds to maintain current services, by reducing the number of participants, or by limiting the services provided to participants.

Some contend that federally sponsored employment and training programs have had little, if any, effect on many participants' earnings. Others argue that one effect of such programs may be that employers substitute the participants for other workers and, therefore, these programs produce no net gain in employment. Further, some maintain that, in a period of overall federal budgetary restraint, states should pay for a larger share of the costs since they receive some of the benefits of having a better trained labor force.

On the other hand, opponents of reductions contend that these programs offer a means of increasing the earnings of disadvantaged and dislocated job seekers, thereby improving the well-being of the participants and their families and reducing future welfare and unemployment insurance costs. Even if total employment were not increased, it is argued, it might be desirable to redistribute job opportunities toward disadvantaged or dislocated workers. Moreover, federal resources for employment and training grants to states have already been cut substantially in recent years--from about $4 billion in 1981 (not including public service employment grants) to about $2.5 billion in 1986.

The Administration's budget also proposed reductions in JTPA budget authority. Its largest cuts, however, would be in the summer jobs and Job Corps programs.

NDD-30 MODIFY THE DAVIS-BACON ACT BY RAISING THE CONTRACT THRESHOLD AND ALLOWING UNRESTRICTED USE OF HELPERS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	590	620	640	670	700	3,220
Outlays	110	330	450	520	560	1,970

Since 1935 the Davis-Bacon Act has required that "prevailing wages" be paid on all federally funded or assisted construction projects of $2,000 or more. Procedures for determining prevailing wages in the construction area and the classifications of workers receiving them sometimes favor union wage rates, although recent changes in regulations have lessened this effect. The act also restricts use of lower-wage, less-skilled workers, such as helpers. Under current regulations, separate wage determinations for helpers are usually not made, with the result that most workers on covered projects are paid journeymen's wages.

Federal outlays for construction could be reduced by raising the threshold for determining projects to be covered by Davis-Bacon, by allowing unrestricted use of helpers, or both. The specific option depicted in the table would raise the threshold from $2,000 to $40,000--the equivalent cutoff level for coverage of the $2,000 value in 1935--index the thresholds to account automatically for future inflation, and allow unrestricted use of helpers. These measures would reduce outlays by about $110 million in 1987 and by about $2 billion over the 1987-1991 period. (Raising the threshold to $1 million and allowing unrestricted use of helpers would reduce outlays over this five-year period by about $2.7 billion.)

Those in favor of relaxing Davis-Bacon standards contend that the act artificially drives up the cost of federal construction projects. Besides reducing outlays for construction, unrestricted use of helpers probably would increase employment levels for less-skilled workers on federal projects. Raising the threshold to $40,000 and indexing it would exclude about 3 percent of the value of all contracts currently covered by the act, whereas setting the threshold at $1 million would exclude 40 percent.

Opponents of such changes contend that making them would expand the use of unskilled labor and lower the wages of construction workers. It is also argued that relaxing Davis-Bacon standards would jeopardize the quality of federally funded or assisted construction projects.

The Administration's budget does not contain any proposals for modifying the Davis-Bacon Act.

NDD-31 CONVERT UNDERUSED ACUTE-CARE BEDS IN VA HOSPITALS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	75	130	190	260	300	950
Outlays	85	120	190	250	310	950

The Veterans Administration (VA) operates a wide range of medical and health-related services, including 172 hospital centers and 114 nursing homes. Because VA hospital centers are experiencing rising demand for long-term care, mainly because of the rapidly increasing veteran population over age 65, the VA has been expanding its number of nursing homes at the rate of about four per year. About 20 percent of VA hospitals have very low occupancy rates, however, and one-tenth of the total acute-care beds are used for patients needing long-term care.

If the VA converted its underused acute-care beds to nursing home care, it could scale back plans for the costly construction of new nursing homes. In some areas, it would even be possible to convert entire underused VA hospitals to nursing homes, which would reduce their staffing and equipment costs. Most underused beds would be immediately available for conversion, whereas others could be converted in later years after improved VA planning and placement of more patients in non-VA nursing homes and outpatient clinics in lieu of keeping them for long stays in VA hospitals.[1] Converting roughly 5,500 of the VA's 78,400 hospital beds would save $85 million in outlays in 1987 and about $950 million over the 1987-1991 period.

Advocates of such conversions point to the prospect of better suiting VA medical services to the patients being treated. They suggest that, because elderly veterans are a growing proportion of VA patients, an imbalance exists in the ratio of hospital to nursing home beds. Opponents counter that aging veterans will need more acute-care treatment as well as services for long-term care. They view the potential closing of hospitals in some areas as reducing access to care for veterans who might prefer VA over private-sector hospital care. Furthermore, existing preferences for VA care could increase if Medicare coverage required higher out-of-pocket payments, or if state Medicaid eligibility requirements became more restrictive in future years.

---

[1] See CBO, *Veterans Administration Health Care: Planning for Future Years* (April 1984).

Legislative action would be required to allow the VA to pursue the conversion of a significant number of hospital beds. Current law now requires the VA to staff and operate at least 90,000 hospital and nursing home beds, and bed conversions could temporarily lower the total number below that minimum. In addition, in areas where VA hospitals were closed or entirely converted to nursing homes, transportation benefits could be expanded to allow veterans to receive VA hospital care in nearby areas, although this would lower savings somewhat.

The Administration's budget would require excess hospital beds to be converted as they were identified. This option would be given lower priority, however, than other proposals in the budget that would place many more veterans in non-VA community and state veterans' homes than in VA-operated homes.

NDD-32 REQUIRE COST SHARING FOR VA HOSPITAL CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	170	310	340	370	400	1,590
Outlays	170	310	340	370	400	1,590

The Veterans Administration (VA) currently provides free hospital care first to veterans with service-connected injuries or illnesses, and then to other special groups of veterans without such disabilities, as beds are available. Among the latter--now 65 percent to 70 percent of all patients--are veterans who claim they cannot defray the costs of care elsewhere and veterans age 65 or older, who are eligible for care without regard to income, health insurance coverage, or financial need. All nonpoor veterans without service-connected disabilities could be required to make copayments equal to those under Medicare for the first 90 days of inpatient care. In 1987, veterans would pay about $552 for the first 60 days of a hospital stay and $138 for each day thereafter. This approach would enable the Congress to reduce VA appropriations so that net outlay savings would be $170 million in 1987 and $1.6 billion over the next five years. (Savings would be net of increases in administrative costs.) These savings would come from copayments by those remaining in the VA system and lower costs of providing VA services because some would seek health care elsewhere.

Proponents of such a change believe the VA's primary responsibility is to provide medical care to veterans with service-connected disabilities. They suggest that, over the next five years, increased demand from growing numbers of veterans reaching age 65 could jeopardize the VA's ability to meet adequately the needs of service-disabled and poor veterans. Establishing deductible amounts and coinsurance requirements for nonpoor veterans without service-related conditions would reduce their use of VA services by making VA care less attractive compared with private alternatives. It would also shift some of the rising costs of medical care to nonpoor recipients, many of whom are accustomed to cost-sharing arrangements at non-VA facilities.

Others suggest that copayment requirements would unfairly burden elderly veterans or limit their access to necessary care. Although VA patients would pay only a small portion of the costs of their care under this option, some opponents object to requiring copayments from combat veterans simply because they are not defined as poor.

The Administration's budget would not require cost sharing for VA hospital care.

NDD-33 LIMIT ELIGIBILITY FOR VA HOSPITAL CARE TO SERVICE-DISABLED AND POOR VETERANS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority	670	1,050	1,150	1,250	1,400	5,520
Outlays	560	870	940	1,000	1,100	4,470

Under current law and practices, the Veterans Administration (VA) provides inpatient hospital care to eligible veterans on a space-available basis, with first priority given to veterans with service-connected injuries or illnesses. If VA-supported hospital care were limited to veterans with service-connected disabilities and those unable to defray the costs of medical care, VA appropriations could be lowered relative to baseline levels, yielding federal savings of $560 million in 1987 and $4.5 billion over the 1987-1991 period. (Savings would be net of increases in both administrative costs and costs to the Medicare program.)

Almost one-fifth of the expected VA patients would be affected by this approach, many of whom would be patients without service-connected disabilities who are over age 65 and not now required to be unable to defray medical costs. In addition, some veterans under age 65 who are currently eligible for VA care would not meet a strict needs test. Financial need could be based on income, with automatic eligibility for those receiving means-tested benefits, such as veterans' pensions and food stamps.

Proponents favor this option principally because they believe that the VA's primary responsibility is to provide care to the service-disabled, and that VA resources should not be expanded solely to meet the future needs of the non-service-disabled. They note that most veterans have access to private hospital care and have adequate insurance for hospitalization.

On the other hand, if the VA served significantly fewer veterans, it might have to scale back its medical school affiliations and, as a result, might no longer be able to provide quality care to some service-disabled veterans. Further, if the VA hospital system was reduced, it might not retain enough reserve capacity for military needs in time of war or national emergency. Opponents also suggest that care for non-service-related ailments was earned as an entitlement during service in the armed forces and any reduction in this care would violate an implicit contract. Finally, some argue that even if this option were adopted, VA appropriations should not be reduced because there would be some eligible veterans who would substitute for those not served.

The Administration's budget would make a similar change in eligibility for VA medical care, and it would allow veterans with higher incomes to become eligible for care after spending specific amounts of their incomes in non-VA facilities. For those non-service-disabled veterans still served, the VA would be given the authority to recover some of the costs of their care from private insurers.

PERSONNEL COSTS

This category presents seven options for reducing the government's costs for travel and for federal employee compensation--mainly pay and retirement benefits. The first option suggests curtailing annual pay adjustments for federal civilian employees. The next two options, PERS-02 and PERS-03, address the outlay savings that would accompany less liberal retirement provisions such as restricting the size of future cost-of-living adjustments. PERS-04 considers the near-term budgetary impacts of pending legislative proposals that would create a new supplemental retirement system for civilian employees covered by Social Security.

PERS-05 would require the U.S. Postal Service to bear the full cost of certain health and retirement benefits that are currently funded by federal taxpayers. The remaining two options would reduce the costs of the Federal Employees Health Benefits Program and limit travel expenses.

The estimated savings for each of the seven options were developed relative to the CBO baseline. Implementing two or more of the options together could reduce the savings below the sum of the amounts indicated for each item.

PERS-01 CAP PAY ADJUSTMENTS FOR FEDERAL CIVILIAN EMPLOYEES

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	800	2,230	3,390	4,500	5,890	16,810
Outlays	820	2,270	3,460	4,580	5,980	17,110

Under current law, the nation's 2.2 million federal employees may receive an annual pay adjustment based on a comparison of federal and private-sector salaries for comparable jobs. More than $17 billion in outlays could be saved over five years if the Congress continued limitations on civilian nonpostal pay raises. (Legislated pay limitations do not apply to the 750,000 postal workers because their wages are fixed through collectively bargained agreements.)

Only once during the past 10 years have annual pay adjustments for federal civilian workers been granted both at the time prescribed and at levels stipulated as necessary to make federal workers' pay comparable to private-sector rates. The successive limitations on pay increases, culminating in no pay raise at all since January 1985, have been adopted largely because of overriding economic and budgetary considerations.

As a result of past austerity, and in terms of current comparisons, federal white-collar salaries are estimated to lag significantly behind private-sector salaries for similar jobs. The salary gaps are large in professional and administrative jobs at entry and higher levels.

This option assumes that pay adjustments for 1987 through 1991 would be tied to the prior-year increase in the Consumer Price Index (CPI); that an additional one-percentage-point reduction would apply to the 1987 and 1988 adjustments; and that a January effective date would continue the three-month delay that was imposed in 1984 and 1985. This approach would assure a reduction in real pay levels, but would limit its extent. The estimated savings are measured against the CBO baseline assumption that annual October adjustments match private-sector pay increases, but not the attained wage and salary levels.

Those who favor further limitations on federal pay increases argue that such action is required to help reduce projected budget deficits despite the potential loss of quality in both the federal civil service and the work it produces. Continued pay caps, proponents also note, would be in keeping with pay austerity measures taken by some private firms and by some state and local governments. They also cite federal personnel practices such as rapid promotions and overgrading of jobs that may offset low pay scales for particular workers. The Administration believes that the size of the federal-private pay gap has been exaggerated by the survey methods used in measuring pay comparability.

Critics of continued pay limitations recognize that full comparability between federal and private pay cannot be achieved at present. They believe, however, that the government cannot continue indefinitely the practice of paying below-scale salaries and wages for large numbers of employees. Their case is reinforced by a management consulting firm report requested by the the House of Representatives. It concludes that federal white-collar salaries in March 1984 lagged behind private-sector salaries, paid by medium-to-large private firms, by an average of 10 percent. When retirement and other benefits are considered, the report shows the lag shrinking to about 7 percent (but two years of continued restraint have probably widened this gap). Despite the debate about differences in levels of pay, opponents of continued pay limitations also note that over the past 10 years federal white-collar pay raises have lagged behind private-sector pay raises by almost 20 percent. Obviously, the 1986 federal pay freeze will accentuate pay disparities.

Continued arbitrary restrictions that result in loss of real income and do not keep pace with private-sector wage increases--let alone pay levels--arguably would lower employee morale and entail the hiring of less experienced and lower-quality workers. The threat to the quality of the work force may be especially worrisome at a time when greater numbers of federal employees may be retiring because of the 1986 pay freeze and because of impending changes in the Civil Service Retirement program. Worker inexperience, while not widespread, has already contributed to documented disruptions of some income tax processing by the Internal Revenue Service. The enormous breadth and variety of federal employment makes it difficult to anticipate the effects of pay limits alone on overall recruitment and retention. Senior workers, for example, derive considerable compensation from federal retirement benefits that are often viewed as recompense for modest salaries while employed. Even where valuable retirement benefits may warrant some pay restraint, the magnitude of current pay disparities has lowered the attractiveness of federal careers, especially for new workers. (Pending reform legislation would restructure the retirement program for new employees, and other retirement changes might also be considered. See PERS-03 and PERS-04.)

The 2.4 percent pay increase provided by this option for 1987 allows more take-home pay than proposals in the President's budget, which provide for a 3 percent pay increase coupled with a 2 percent-of-pay offset for higher mandatory withholdings for civil service retirement. At first glance, the combined effect of the President's plan seems to offer a 1 percent increase in take-home pay. But employees in high tax brackets would face a decline in disposable income as the combined rise in taxes and retirement withholdings would exceed the pay increase.

PERS-02 ELIMINATE COST-OF-LIVING ADJUSTMENTS FOR FEDERAL RETIREES UNDER AGE 62

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Military Retirement	270	750	1,230	1,730	2,220	6,200
Civilian Retirement	90	200	220	220	200	930
Total	360	950	1,450	1,950	2,420	7,130

The Civil Service Retirement (CSR) and Military Retirement (MR) systems now provide benefits for about 3.4 million people at an annual cost of $42 billion. About 60 percent of MR beneficiaries and 13 percent of CSR beneficiaries are nondisabled retirees under age 62. Benefit payments in 1986 for this relatively young group exceed $14 billion. Cost-of-living adjustments (COLAs) for federal retirees that begin before age 62 are expensive, superior to those provided private-sector retirees, and fully paid for by the government. This option, a two-step approach, would eliminate COLAs for nondisabled retirees under age 62; grant a catch-up raise at age 62 equal to the accumulated rate of inflation since retirement; and provide full COLAs thereafter. It would reduce outlays through 1991 by $7 billion. About 82 percent of this savings would derive from current retirees, and the rest from those retiring in the next five years.

Recent budget reduction measures have restricted the size and timing of COLAs for all annuitants receiving federal retirement, disability, and survivor benefits. Most recently, the 3.1 percent increase scheduled for January 1986 was permanently eliminated by the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177). The President's budget proposals for 1987 would extend the federal COLA freeze one more year--regardless of the annuitant's age or ability to work. Social Security COLAs, by contrast, would not be curtailed. (ENT-12 would restrict federal retirement and Social Security COLAs.)

COLAs for federal retirees generally equal 100 percent of inflation, as measured by the annual change in the CPI, regardless of the recipient's age.

Social Security COLAs, on the other hand, are automatic and keep pace with inflation, but employees cannot draw Social Security retirement until age 62. In addition to Social Security, less than half of the retirees in the private sector also are covered by employer-provided pension plans. These individuals typically receive pension COLAs, on an ad hoc basis, that eventually recover nearly 40 percent of general price increases.

This option, if adopted, would reduce inflation protection and thus real benefits for federal retirees of working age. It would dramatically reduce benefits for MR employees, who retire at an average age of 43. At age 62 and beyond, however, the option would completely index federal pensions for price increases since retirement. The ensuing adjustments, with the catch-up, would remain more generous than the partial inflation protection for those receiving private pensions combined with Social Security.

Because considerable planning and changes in personal affairs often precede decisions to retire, opponents of this option argue that changing the rules for people after they retire or for those close to retirement is unfair. Further, some believe that future budgetary pressures may either erode the size of the catch-up adjustment or delay it beyond age 62. Critics also note that this proposal penalizes retirees who have served the government for at least 20 years--the very employees the retirement systems were designed to reward. CBO estimates that this option would ultimately induce the loss of 50,000 military personnel with over four years of service, and would thus engender a shift to a less experienced and lower-skilled military force. Although this junior force would have smaller pay and benefit costs than the present one, the government's recruitment, training, and turnover costs would rise.

Proponents counter that in order to realize large deficit reductions the Congress must consider alternative COLA provisions that generate considerable near-term savings. One possibility, incorporated in the President's budget and in the sequestration mechanism of the Balanced Budget Act, is to curtail adjustments for all federal annuitants. Other alternatives could pivot directly, or indirectly like this option, on the beneficiary's earnings ability. In general, financial hardships from smaller COLAs would be more pronounced for disabled and survivor annuitants than for the relatively young retirees targeted by this option, who should be in a better position to accommodate a temporary loss in real benefits. Presumably, these young retirees are able to supplement their federal pensions by working--as most military retirees already do.

PERS-03 REDUCE CIVIL SERVICE RETIREMENT BENEFITS

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	--	60	130	180	220	590
Outlays	100	240	300	380	460	1,480

Nearly all federal civilian workers hired after December 1983 participate in Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) programs and a yet-to-be-defined supplemental retirement plan. But 1.9 million annuitants and 2.4 million workers, including employees of the U.S. Postal Service, participate in a retirement program that predates and remains independent of Social Security--the Civil Service Retirement (CSR) system. Compared with the costs of Social Security retirement benefits coupled with typical private employer-provided pensions and capital accumulation plans, CSR benefit costs are high.

The following modifications would bring CSR provisions for current participants closer to those of the private sector and also reduce budgetary costs. They are similar to changes proposed by the President's budget for 1987, except that employee contributions would not change. (Under the President's budget, CSR contributions for most employees would increase from 7 percent to 9 percent of pay.)

- Eliminate cost-of-living adjustments (COLAs) for nondisabled retirees under age 62; grant a catch-up raise at age 62 equal to the accumulated inflation rate since retirement; and provide full COLAs thereafter; this would yield 1991 outlay savings of $200 million. (The change would affect new as well as current CSR retirees; see PERS-02.)
- Change gradually, over the next four years, the salary base used to calculate benefits from a three-year to a five-year average; this would yield 1991 savings of $180 million.

- Phase out, by 1991, the crediting of unused sick leave as years of service when calculating initial retirement benefits; 1991 savings would be $50 million.

- Reduce benefits (earned after October 1986) by 2 percent for each year a person retires before age 62; 1991 savings would be less than $50 million.

With the exception of the provision to restrict COLAs, these modifications would yield relatively small outlay savings in the first five years. But as more and more employees retired, significant savings would accrue from the non-COLA benefit reductions. In particular, on an actuarial or long-term accrual cost basis, the COLA proposal would save less than 0.5 percent of payroll, while the change to a five-year average salary base would save more than 1.5 percent. (See PERS-02 and ENT-12 for other measures that would affect federal retirement benefits.)

Opponents of any cut allege that CSR is part of an "implicit contract" that has linked a generous retirement system to salaries held below market rates. (See PERS-01 regarding continued limitations on federal pay raises.) They also believe it premature to adjust CSR benefits until the dimensions of the forthcoming supplemental retirement program for new federal workers are known (see PERS-04). Finally, many argue that it is inequitable to curtail COLAs for federal workers who are already retired unless similar cuts apply across the board and affect retirees receiving Social Security.

The courts, proponents would respond, have determined that prospective COLAs for federal retirees are not guaranteed. In fact, the Balanced Budget and Emergency Deficit Control Act of 1985 permanently eliminated the federal retirement COLA scheduled for January 1986 and may eliminate future COLAs through 1991. Proponents also note that federal retirement's full COLA provisions, its availability of unreduced retirement benefits at age 55 after 30 years of service, and its basing of benefits on highest average annual earnings over three consecutive years are more generous than the pension practices of private employers. Private pensions typically award COLAs on an ad hoc basis, reduce initial benefit levels for retirement prior to age 62, and base annuities on highest average earnings over five years rather than three years. But private pensions are also integrated with Social Security payments, making comparisons between federal and private benefit practices difficult.

PERS-04 ESTABLISH SUPPLEMENTAL FEDERAL RETIREMENT BENEFITS FOR NEW WORKERS

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
S. 1527	130	240	300	340	350	1,360
H.R. 3660	280	430	540	650	790	2,690

NOTE: For comparative purposes, the estimated savings combine outlay and revenue reductions that pertain to newly hired workers. The potential budgetary effects if current federal employees were allowed to switch to a new retirement plan are not considered.

The Congress is now considering two legislative proposals, H.R. 3660 and S. 1527, that would create a new supplemental retirement system for nearly all federal civilian employees hired after December 1983. Under current law, these workers must participate in Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) programs. In weighing which bill to adopt, or whether to choose some other course, the Congress will consider the effects of the benefit packages on recruitment and retention goals and gauge the potential for long-term savings in personnel costs. But it will also be concerned with the short-term budgetary impacts, which are assessed here.

A key difference between the proposals is the government's long-term accrual cost for new employees as a group. In addition to employer OASDI contributions, which would average about 6 percent of payroll, the Senate bill would generate an accrual cost to the government of 16 percent of annual payroll, according to Congressional Research Service estimates. Thus, in the long run, retirement would cost 22 percent of payroll. Under identical economic and demographic assumptions, the House plan would cost an estimated 25.3 percent of payroll, about the same as the current Civil Service Retirement system. Only the Senate approach, although it too is more generous than the typical private retirement system, would offer the prospect of long-term budgetary savings.

Both bills would add two tiers of payments to OASDI benefits: a voluntary savings plan that would encourage employee participation through a government match; and a defined-benefit tier or pension. The voluntary savings plan would be portable in that a departing worker would retain ownership of his or her savings account. Pension benefits would be based on years of federal service--including military service--but on a different earnings base (average pay of highest five years for S. 1527 versus the highest three years both for the current system and for H.R. 3660). A detailed comparison of the bills is complicated by the fact that employees would choose between two approaches under S. 1527, referred to as Options A and B. The first option would emphasize the voluntary savings plan relative to the defined-benefit tier. It would facilitate job mobility, which is especially appealing to younger workers and to those not planning to retire as federal employees. Option B and H.R. 3660 would provide more generous cost-of-living adjustments (COLAs), require larger employee contributions, and place greater weight on the defined-benefit plan, the tier most appealing to prospective career civil servants.

Either bill, if enacted, would lower budget deficits over the next five years. Estimated near-term budgetary savings for both bills derive from two common sources. First, some employee contributions to the voluntary savings plans would be retained by the government as special U.S. securities. By current accounting conventions, this would lower the deficit. Second, both bills would require the U.S. Postal Service to pay its fair share of the new supplemental retirement plan costs, which this estimate assumes would come from increased postage rates. (The estimate assumes the higher postal costs for retirement would be funded in the year incurred. If not, postal revenues would rise in subsequent years.) In addition, H.R. 3660 requires employee contributions and does not allow savings plan contributions to be deducted from taxable income, while the Senate bill, in extending Section 401(k) of the Internal Revenue Code to federal employees, would allow deferral of taxes on any contributions to the voluntary savings plans until those amounts were withdrawn. These differences account for most of the much greater savings under the House plan. But these short-term budgetary gains, relative to the Senate bill, would be offset in later years by higher pension payments.

PERS-05 REQUIRE THE POSTAL SERVICE TO PAY THE FULL COST OF RETIREMENT AND OTHER BENEFITS

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Budget Authority a/	--	--	-460	-660	-350	-1,470
Outlays	--	--	1,100	1,350	1,550	4,000

a. Negative amounts denote a net rise in budget authority because the Postal Service would need additional borrowing authority.

The U.S. Postal Service (USPS) does not pay the full employer cost of its employees' retirement benefits or its retirees' health care benefits. Shifting the cost of these indirect subsidies from federal taxpayers to mail users--less than 20 percent of which are households--would generate federal outlay savings through 1991 of $4 billion. The savings would result from increased postage rates.

This option proposes eliminating the indirect USPS subsidies the next time postal rates are increased. (The President's budget would gradually phase out the retirement subsidy, beginning in 1987, and immediately eliminate the health care subsidy.) For estimating purposes, CBO assumes that first-class rates would increase in January 1989 by an extra 4 percent for the indirect health care and retirement costs induced by this option. The 4 percent increase would be in addition to a projected 14 percent rise that would occur, at the same time, in response to higher postal operating costs. The 18 percent total increase would result in a 26-cent first-class stamp. Changing the assumed date that postage rates increase would affect the estimated budgetary savings.

Many analysts have observed that federal subsidies give the USPS an unfair market advantage over competing private-sector firms, leading to overuse of the USPS. Eliminating the indirect subsidies would move the USPS closer to self-sufficiency. 1/ In the view of proponents, this would

---

1. See also CBO, *Curtailing Indirect Federal Subsidies to the U.S. Postal Service* (August 1984).

also give the Postal Service an incentive to lower costs by improved efficiency while, at the same time, reducing the federal budget deficit. (Other budget reduction measures that would affect the Postal Service include PERS-04, NDD-04 and NDD-19.) As an alternative to this option, some analysts might favor letting the USPS set up independent retirement and health care programs through collective bargaining.

Opponents would argue that it is unfair to charge the USPS for the full cost of health care and pension benefits when current law prohibits postal-labor negotiations on these issues. In addition, the USPS might oppose higher retirement payments unless the estimated cost of pension benefits specifically reflects the somewhat special characteristics of the USPS work force, rather than those of all participants in the federal retirement system. (For example, career advancement and turnover patterns for postal employees differ from those of other federal workers.) But the use of a common cost factor for all employees under the same retirement plan is consistent with the recently adopted approach to military retirement, which covers different types of personnel including Air Force officers and Army enlistees.

PERS-06 MODIFY THE FEDERAL EMPLOYEES HEALTH BENEFITS PROGRAM

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	60	120	190	270	360	1,000
Outlays	60	120	190	270	360	1,000

The Federal Employees Health Benefits (FEHB) program offers health insurance coverage for federal employees and annuitants (that is, retirees) and their dependents. In 1985, the program covered about 3.8 million enrollees at an annual premium cost to the federal government of approximately $3.3 billion. About half of this amount was paid to hospitals for services provided to FEHB enrollees.

Program costs could be reduced by reforming hospital reimbursement procedures. Currently, FEHB insurance carriers pay hospitals on a "reasonable" cost basis. An alternative reimbursement system could require carriers to use a prospective payment system similar to that now used by Medicare. Under Medicare, hospitals receive a flat payment per case based on a patient's diagnosis. Applying a similar reimbursement system to FEHB based on diagnosis-related groups (DRGs) would entail modifying the payment schedule to reflect the health care needs of younger patients. Any hospital that accepts federal reimbursement from Medicare could be required to accept the predetermined rate as payment for FEHB enrollees. A hospital would be prohibited from charging enrollees more than the DRG amount the carriers are required to pay.

Savings realized by FEHB insurance carriers under this prospective payment system would allow for lower premium payments by both enrollees and the federal government. The five-year savings of $1 billion shown above represents only the federal budgetary savings. This estimate assumes that annual increases in DRG reimbursements would be tied to the hospital price index plus an additional 0.25 percent to permit technological advances. (The President's budget proposes a voucher system that would limit the annual rise in agency FEHB premiums to the implicit price deflator for the gross national product. If implemented on schedule, it would reduce outlays through 1991 by nearly $5 billion.)

Advocates of bringing FEHB under a prospective payment system argue that hospitals would be less able to shift costs from Medicare to other third-party payers, like FEHB carriers, that currently reimburse without DRG limits. In addition, some proponents believe that an expanded DRG reimbursement system would also reinforce existing incentives for hospitals to contain costs. In their view, the current system drives up costs because hospitals tend to provide FEHB patients more amenities, more technology, and more staff than are necessary. A DRG system, by contrast, seeks to increase hospital efficiency while maintaining the quality of health care.

Opponents of this proposal would voice many of the same concerns about jeopardizing quality health care that were raised during debate on adopting the DRG scheme for Medicare. Because the payment does not recognize costs actually incurred on behalf of each patient, hospitals would profit from cases where a patient was healthier than average, and would suffer a financial loss when a patient was sicker than average. Under such economic incentives, opponents argue, hospitals might avoid treating patients with severe illnesses, might encourage profitable admissions of those with minor health problems who do not necessarily require hospitalization, and might discharge some patients prematurely. Some critics are also concerned that over time DRG relative prices might diverge from costs, causing hospitals to accentuate the selection of patients on the basis of profit considerations. In addition, hospitals might incur excessive costs to set up a DRG accounting system to serve the relatively small numbers of younger FEHB patients in many areas.

PERS-07 REDUCE FEDERAL TRAVEL EXPENSES

Savings from CBO Baseline	Annual Outlay Savings (millions of dollars)					Cumulative Five-Year Savings
	1987	1988	1989	1990	1991	
Budget Authority	580	610	650	690	730	3,260
Outlays	530	560	600	630	670	2,990

The Executive Branch spends about $6 billion a year on employee travel. Appropriation action requiring a 10 percent across-the-board cut in travel expenses would save, relative to the CBO baseline, about $3 billion over five years. About 70 percent of this savings would arise from reductions in military travel. Although travel estimates vary widely among individual accounts, the totals in the President's budget reflect a slight decrease relative to the 1987 baseline estimates, with amounts for military travel growing at a faster rate than those for civilian employee travel.

The General Services Administration (GSA) and Department of Defense (DoD), which manage travel arrangements for civilian and military personnel, respectively, report that recent improvements in procurement methods have reduced government travel expenses. Despite these achievements and an across-the-board limit on the 1982 travel budget required by the Omnibus Budget Reconciliation Act of 1981, the amount of travel dollars spent per employee increased by 43 percent between 1980 and 1985, while prices for travel services during the same period increased by only 36 percent. Although the improvements implemented by GSA and DoD have eliminated some travel expenses, the General Accounting Office states that additional changes in travel management could produce further savings.

Proponents argue that an across-the-board reduction in 1987 would prompt agencies to pursue cost-saving practices more aggressively. Possibilities include better monitoring of costs, elimination of low-priority travel, and greater use of innovative procurement methods like negotiated discounts for high-volume travel. With improved management, they say, agencies could achieve reductions without significantly cutting back travel.

On the other hand, enactment of a 10 percent travel limitation runs the risk of creating difficulties for programs that rely heavily on travel for effective management. Agencies with many field offices or contractors, for example, may face inefficiencies or added costs in other areas if required to make cuts in travel. Opponents of a limitation on travel point out that the risk of inefficiencies increases as possible management improvements and cuts in low-priority travel are exhausted. Additionally, some substitutes for travel, such as telecommunications equipment purchases, could prove more costly. From this perspective, singling out travel is less preferable than a general reduction in administrative expenses, the approach taken in the Balanced Budget and Emergency Deficit Control Act of 1985. Finally, some would argue that limitations in military travel would interfere with national defense activities. If military travel was exempted from the 10 percent reduction, however, the budgetary savings would greatly diminish.

REVENUES

This category presents 35 options for increasing revenues from federal taxes. The first three options concern increases in income tax rates for individuals and corporations. Options numbered REV-04 through REV-06 discuss taxes on consumption, including a new value-added or retail sales tax, new or increased taxes on energy, and extensions or increases of existing excise taxes.

Most of the options suggest ways to broaden the base of the income tax, by reducing or eliminating the revenue losses stemming from tax preferences. REV-07 through REV-09 would reduce investment tax preferences that were created to encourage capital formation generally. REV-10 through REV-15 would alter tax preferences aimed at particular industries or activities. REV-16 through REV-20 would reduce preferences that make some forms of saving more attractive than others. The remaining options for broadening the income tax base (REV-21 through REV-29) concern tax preferences that do not directly encourage saving or investment.

Other options include REV-30, which is aimed at improving compliance with income tax laws; REV-31 and REV-32, which describe ways to reduce most tax preferences through across-the-board percentage cuts or by imposing minimum taxes; REV-33 and REV-34, which describe ways to reduce the revenue loss attributable to the possessions and foreign tax credits; and REV-35, which would reduce the tax preference for passing appreciated capital assets to one's heirs.

The discussions of base-broadening options refer to, and in some cases duplicate, the provisions of the President's tax reform proposal [1] and the tax reform bill passed by the House in December 1985 (H.R. 3838). The revenue estimates in this volume for each option assume that other provisions of the tax law, including the rate structure, are unchanged. Thus, they may differ from estimated effects of similar provisions in the reform proposals, which may have been estimated under a different rate structure and different effective dates and transition rules.

---

1. *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985).

The estimates of revenue gains from all of the options were made relative to the CBO baseline budget forecast. The baseline is developed under the assumption that most provisions of the tax code that are currently scheduled to expire, or that expired on December 31, 1985, will not be extended or reinstated. If, for example, tax preferences scheduled to expire between 1986 and 1991 were extended, they would make a difference of $32.0 billion in fiscal years 1987-1991 relative to the CBO baseline. These tax preferences and other provisions scheduled to expire in future years are described in CBO's report, *The Economic and Budget Outlook: Fiscal Years 1987-1991*, pp. 104, 105.

Most of the options have an effective date of January 1, 1987. For a few of the options (primarily those affecting taxes on consumption), an earlier date of October 1, 1986, is assumed in order to increase revenue yields in 1987. A January 1, 1988, effective date is assumed for REV-04 (the value-added tax) because it is believed this option cannot be implemented immediately.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Raise Marginal Tax Rates 5 Percent	13.3	19.1	20.6	22.1	23.8	98.9
Raise Marginal Tax Rates 10 Percent	26.7	38.4	41.3	44.4	47.7	198.5

Under the current income tax structure, marginal tax rates range from 11 percent to 50 percent. (The marginal rate is the rate of tax that a person must pay on an extra dollar of income.) A 10 percent across-the-board increase in marginal tax rates, raising them to between 12 percent and 55 percent, would increase revenues by almost $200 billion between 1987 and 1991.

The main advantage of increasing marginal tax rates is that it could raise a significant amount of money quickly and easily. Raising tax rates is quite straightforward administratively. Because the bulk of the income tax is collected in the form of payments withheld from employee paychecks, the added revenue would begin to flow into the Treasury as soon as employers changed their payroll accounting practices (usually in one to three months). In addition, because the income tax is progressive, even after accounting for exemptions and deductions, higher marginal rates would result in a greater proportionate reduction in after-tax income for upper-income than for low-income people.

A rate increase may have undesirable effects, however. Most taxpayers have marginal rates that are fairly high, compared with historical levels, despite the reductions enacted in 1981. High marginal rates may discourage working, saving, and investing, and raising them would make this problem worse.

Higher tax rates would also exacerbate economic distortions resulting from provisions that discriminate among sources and uses of income. These provisions reduce economic efficiency by biasing the allocation of resources toward tax-favored activities. Increases in tax rates on those in the top brackets can especially distort savings and investment decisions.

In addition to their economic costs, tax rate increases may be perceived as unfair because they most heavily affect people who are already paying taxes, especially those who now pay at high rates. Taxpayers who are able to reduce their tax bill (or escape taxation altogether) by taking advantage of special provisions of the law are significantly less affected (or not affected at all). If the tax base were broadened by eliminating some or all of these special provisions, as is proposed in most current tax reform plans, then subsequent tax rate increases might not be as unfair because most (if not all) taxpayers would share the additional burden.

Raising marginal income tax rates is contrary to the goals of current efforts to reform the income tax system. All major tax reform proposals would broaden the tax base, decrease the number of tax brackets, and reduce the statutory rates. If marginal rates were raised, subsequent attempts to broaden the tax base might be received with less enthusiasm because, at higher rates, each base-broadening change in the system would cost taxpayers comparatively more.

REV-02 AMEND OR REPEAL INDEXING OF INCOME TAX RATES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Repeal Indexing	4.4	12.7	23.6	36.7	51.9	129.3
Delay Further Indexing Until January 1, 1988	4.4	7.3	7.8	8.5	9.1	37.1
Index for Inflation in Excess of 3 Percent	3.8	10.4	18.1	27.0	37.4	96.7

This year, as in 1985, the rate structure of the individual income tax will be adjusted to offset the effects of recent inflation. The personal exemption and the boundaries of each statutory tax bracket (including the zero bracket amount) were increased 4.08 percent in 1985 and will be increased 3.7 percent this year to reflect the change in the Consumer Price Index experienced during the previous years. A similar adjustment will be made annually in future years.

Many changes have been proposed to reduce the effects of indexing. Ideas include outright repeal, delay of indexing, and partial indexing for inflation above some threshold rate only. The additional revenues that would result from three frequently discussed proposals are shown in the table above.

Changes in indexing would gain smaller amounts of revenue in their first year of enactment, but would raise considerably larger amounts in future years because of the cumulative effects of indexing. The significant reduction in the deficit, especially in later years, is one of the main arguments in favor of cutting back on indexing.

Another advantage of amending or repealing indexing is that it would not single out any particular group of taxpayers, but rather would apply to everyone by changing the tax structure across the board. In addition, it would be easy to carry out administratively. Repeal or delay of indexing could be accomplished simply by not changing the bracket boundaries and the personal exemption for one or more years. Indexing for inflation in excess of a specified rate would be done precisely as indexing is done now, except that a smaller percentage change would be applied to the exemption amount and the bracket boundaries.

Arguments against changing indexing are both economic and political. In economic terms, reducing indexing would increase marginal tax rates for many taxpayers by allowing inflation to move them into higher tax brackets even when their incomes in constant dollars were unchanged. Therefore, it would reduce economic efficiency to the extent that higher marginal tax rates bias the allocation of resources toward tax-favored activities, and could also reduce work effort and saving. At the same time, the incentive effects of reducing indexing would not be exactly the same as for explicit across-the-board increases in marginal tax rates. For example, taxpayers in the 50 percent bracket would not experience an increase in their marginal tax rate, even though their average tax rate would rise.

On political grounds, proponents favor indexing because it requires the Congress to decide explicitly on tax increases. Without indexing, inflation causes more-than-proportional increases in tax liabilities as incomes rise. This results in increased *real* tax burdens without legislative action even though *real* income increases may not have occurred. In contrast, indexing forces the Congress to enact tax increases if it wants to increase the ratio of federal revenues to GNP; it must then decide directly about the desirability of a larger public sector. Conversely, an unindexed tax system provides a politically easy way to raise revenues and lower deficits.

The revenue gains from either complete elimination of indexing or delay of indexing for one year would be highly sensitive to inflation; for higher rates of inflation, the revenue increase from eliminating indexing would be greater. (This also means that, in the absence of indexing, average tax rates paid by individuals would rise much faster if inflation increased.) On the other hand, the revenue pickup compared with current law from indexing for inflation in excess of 3 percent would be less sensitive to changes in inflation (unless inflation fell below 3 percent), and taxpayers would still be somewhat protected from the effects of increases in the rate of inflation.

Both elimination of indexing and a uniform percentage increase in marginal tax rates would increase taxes more for high-income than for low-income taxpayers, both in absolute terms and as a percentage of income (see REV-01). In that sense, both ways of raising tax rates would reduce inequality in the after-tax distribution of income. For the same revenue gain, however, elimination of indexing would increase taxes relatively more for low-income people than would a constant percentage increase in marginal tax rates. This would occur mainly because a smaller proportion of low-income families itemize than do high-income families. If indexing were eliminated, nonitemizers would lose the benefit of increases in both the personal exemptions and the zero bracket amount (ZBA), while itemizers would not be affected by the failure to index the ZBA. As a result, the percentage increase in taxes paid would be greater for nonitemizers (mostly low- and middle-income) than for itemizers (mostly high-income).

REV-03 IMPOSE A CORPORATE SURTAX

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Surtax on Tax Before Credits						
10 Percent	7.8	13.9	15.1	15.8	16.1	68.8
5 Percent	3.9	6.9	7.5	7.8	7.9	33.9
Surtax on After-Tax Economic Income						
5 Percent	10.8	18.3	20.7	23.3	24.9	97.9
2.5 Percent	5.4	8.8	10.0	11.3	12.1	47.6

Imposing a corporate surtax has recent historical precedent. As a temporary measure to help pay for the Vietnam War, a surtax was imposed on individual and corporate taxes from January 1, 1968, to December 31, 1969, at the annual rate of 10 percent, and from January 1, 1970, to June 30, 1970, at the annual rate of 5 percent. For most corporate taxpayers, a 10 percent surtax comparable to the Vietnam War surtax would be equivalent to raising the marginal statutory tax rate 4.6 points--from 46 percent to 50.6 percent. A 10 percent surtax would raise almost $70 billion between 1987 and 1991; a 5 percent surtax would raise $34 billion over the same period.

A surtax is a relatively simple means of raising a significant amount of revenue quickly, and in a way that may be temporary if desired. Proponents of a surtax on individual incomes generally include a corporate surtax at the same rate on grounds of equity. The principal objection to a surtax is that it increases the tax burden most for those firms that already pay the most taxes, thereby exacerbating a major problem of the current corporate income tax--that it results in widely differing effective tax rates, both across and within industries. Moreover, if the surtax was temporary, provisions in current law that allow deferrals of taxable income, such as accelerated depreciation, could become forgiveness rather than deferral of surtax liability. This would further increase the value of these tax preferences and the unevenness of the corporate tax burden.

An alternative is to impose a surtax on a comprehensive measure of after-tax income. For example, the surtax could be imposed on business receipts minus allowable business expenses such as wages and salaries, cost of materials, payments to qualified pension plans, and straight-line depreciation of business assets. Asset lives would be approximated by 40 years for structures and by midpoint lives for equipment under the Asset Depreciation Range (ADR) system in effect before 1981. Thus, for this surtax, the tax base would become income already subject to the regular tax plus fringe benefits and most business tax preferences; it could be reduced by the regular income tax, and by an exclusion of $100,000. Imposition of a 5 percent surtax on this base would raise $98 billion between 1987 and 1991; if the rate was 2.5 percent, the net revenue increase would be $48 billion.

The advantage of this approach is that such a surtax, which can also be described as an additional minimum tax on after-tax economic income, would fall most heavily on those corporations that currently make considerable use of tax preferences. Thus, unlike the surtax on tax before credits, it would reduce the value of those corporate preferences. It would tax all income above the exclusion, including income sheltered from the regular tax by deferrals. If a corporation had an effective tax rate of 46 percent on its economic profits, a 5 percent surtax on economic income would increase its effective rate 2.7 points, to 48.7 percent. If it had an effective tax rate of zero, this surtax would increase its effective rate to 5 percent.

One objection to a surtax on after-tax economic income is that it would raise corporate taxes even for those corporations not using tax preferences, although by a lesser amount than a surtax on tax liability that raised the same net revenue. Alternatives that would raise taxes only for those corporations using preferences to reduce tax liability are discussed in REV-31 and REV-32.

REV-04 IMPOSE A VALUE-ADDED OR NATIONAL SALES TAX

Addition to CBO Baseline a/	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
5 Percent Tax, Comprehensive Base	--	71.2	107.7	115.8	124.8	419.5
5 Percent Tax, Narrower Base, Exemptions for Food, Housing, and Medical Care	--	42.4	64.1	69.0	74.3	249.8
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Means-Tested Programs b/	--	56.0	84.9	91.2	98.1	330.2

a. Estimates based on effective date of January 1, 1988.

b. Includes increased outlays for Medicaid, Food Stamps, Medicare, Supplemental Security Income, and Aid to Families with Dependent Children.

A national value-added or retail sales tax could raise substantial revenue at relatively low tax rates. A common way of administering a value-added tax is to collect a tax on the total value of sales of all firms, but allow them to claim a credit for taxes paid on goods purchased from other firms. Creditable purchases include those of natural resources (including energy), intermediate materials, and capital goods. Wages, salaries, profits, and interest are not creditable because they have not been previously taxed and represent the "value added" by a firm.

A value-added tax (VAT) is essentially equivalent in economic effect to a national retail sales tax. Either type of tax could be fully comprehensive, or could allow exemptions for certain goods and services. In addition to exemptions for charitable, religious, and educational institutions, the tax might allow exemptions for necessities, thereby reducing the regressivity of the tax. These might include food consumed at home, all housing, and medical services, among others. Ease of administration might also justify exemptions for items such as the imputed value of services of financial institutions, the imputed rent from owner-occupied housing (though sales of new homes could be taxed), and sales by small businesses and farms.

Currently, the United States relies much less on consumption taxes than do most other countries belonging to the Organization for Economic Cooperation and Development (OECD)--many of which already impose a VAT. A major argument for introducing a VAT or national retail sales tax to raise a significant amount of revenue in this country is that it would be more neutral among economic activities than an equal-revenue increase in income tax rates. In addition, a VAT or retail sales tax would be neutral between present and future consumption, and therefore would not adversely affect incentives for saving and investment as much as an equal increase in income taxes. (Like an income tax, however, it would reduce rewards from work effort.) Some people also favor a VAT or a sales tax because it taxes imports and exempts exports, which could improve the nation's trade balance. Finally, there is some evidence from public opinion polls that the public regards increases in sales taxes as a fairer way of raising revenue than increases in the income tax.

The major argument against a national sales tax is that it is regressive because it must be imposed at a flat rate and because the ratio of consumption to income falls for people in higher income classes. The regressivity of a sales tax may be overstated, however, by using current rather than lifetime income as a measure of ability to pay and, in any case, is mostly correctable as explained below. Other arguments against a national sales tax are that any increase in the price level it induces might have further inflationary repercussions, and that states would regard a federal sales tax as interfering with their traditional revenue base. In addition, a federal sales tax would require new enforcement procedures and additional IRS personnel and might take one or two years to implement fully; therefore, it should be considered only as part of an effort to raise a significant amount of revenue. (For example, the Department of Treasury has estimated that a VAT would require 20,000 additional personnel at a cost of $700 million.) Finally, the revenue-raising potential of a federal sales tax is a concern among those who fear it might facilitate undue growth of the federal government.

The regressivity of a value-added tax could be alleviated by exemptions for goods and services consumed by low-income persons. Such exemptions would, however, substantially increase costs of enforcement and compliance, especially over time as new items considered worthy of special treatment were added to the list. An alternative approach to offsetting regressiveness that would be easier to administer is to allow additional exemptions or credits for low-income people under the federal income tax.

The derivation of two tax bases for a VAT is shown in the accompanying table. The first base is as broad as possible, excluding only those items that would be administratively very difficult to include. The second adds exemptions for food, health care, and other expenditures. For 1984, the comprehensive base is equal to $2.1 trillion, while the more narrowly defined base amounts to $1.3 trillion.

A 5 percent tax on the comprehensive VAT base would raise an estimated $71 billion in fiscal year 1988 and $420 billion over the 1987 to 1991 period, net of reduced personal and corporate income taxes. (Personal and corporate taxes would be reduced by a VAT because the tax would reduce personal and corporate incomes, assuming nominal GNP remained constant.) The narrower-based VAT would raise $42 billion in fiscal year 1988 and $250 billion between 1987 and 1991. This estimate assumes that collections would not begin until January 1, 1988.

A third option is to include food and medical care in the narrower tax base, but to provide low-income relief through payments to low-income individuals through means-tested programs such as Medicaid, Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and Food Stamps. Since medical care would be subject to the VAT, Medicaid and Medicare benefits would automatically be adjusted to reflect the tax. A 5 percent increase in Food Stamp, AFDC, and SSI benefits would compensate low-income persons for taxes on food, as well as partially offset taxes on other purchases. After accounting for the costs of these additional outlays, this option would reduce the deficit by $56 billion in 1988, and about $330 billion in the years 1987 through 1991.

Value-added taxes have been the subject of recently proposed legislation in other contexts. In 1985, the Senate passed a bill that included a low-rate (0.08 percent) VAT on manufacturers to finance additional Superfund outlays. The tax would be limited to manufacturing companies with sales of over $5 million. Another, more comprehensive, VAT--referred to as a business transfer tax (BTT)--has been proposed in the Senate (S. 1102). The BTT in its most recent version is a broad-based VAT with a tax rate between 7 percent and 10 percent. The BTT's receipts would be used to finance lower individual and corporate tax rates, more generous capital recovery provisions, and expanded IRA accounts for individual savers. Depending on the tax rate, any net revenue from the BTT could be used for deficit reduction.

CALCULATION OF TAX BASE UNDER A VAT, 1984

Items Included		Amount (In millions of dollars)	Gross Tax at 5 Percent Rate (In millions of dollars)
Total Personal Consumption in GNP		2,341,781	
Less:	Rent on housing	397,873	
	Net foreign travel expenditures	11,240	
	Religious and welfare activities	35,165	
Plus:	Monetary interest paid by individuals	77,800	
	New residential construction	149,874	
Comprehensive VAT Tax Base		2,125,177	106,259
Possible Exemptions			
	New residential construction	149,874	
	All medical care	258,309	
	Food purchased for off-premise consumption	311,035	
	Food furnished employees	6,797	
	Clothing issued to military personnel	120	
	Domestic services	8,075	
	Financial services provided free of charge	55,822	
	Expense of handling life insurance	26,621	
	Local transit (excluding taxis)	4,069	
	Clubs and fraternal organizations	3,139	
	Private education and research	35,403	
Narrower VAT Tax Base		1,265,913	63,296

SOURCE: Congressional Budget Office.

REV-05 INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Impose Tax on Domestic and Imported Oil ($5 per barrel)	20.4	21.8	22.1	22.5	22.9	109.7
Impose Oil Import Fee ($5 per barrel)	7.4	7.3	7.4	7.8	7.9	37.8
Impose Excise Tax on Natural Gas ($1 per 1,000 cubic feet)	12.0	12.9	13.2	13.6	13.7	65.4
Increase Motor Fuel Excise Tax (12 cents per gallon)	10.4	10.7	10.9	10.9	10.9	53.8
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	13.9	15.2	16.2	17.3	18.5	81.1

NOTE: These added revenues are net of any estimated changes in income, windfall profit, and other taxes that might result from each option. Induced outlay effects are not estimated. These estimates are based on CBO's baseline oil price forecast of $23.60 per barrel in 1987, rising to $27.50 per barrel by 1991. To the extent that oil prices differ from this forecast, revenues may be significantly affected. The effective date for all of these proposals is October 1, 1986.

Energy taxes could raise significant amounts of revenue, reduce the country's dependence on foreign oil suppliers, and increase conservation by making energy more expensive. The United States depends on foreign sources for about 30 percent of the oil it consumes, and about 11 percent of its total energy. This dependence exposes the U.S. economy to potential supply interruptions.

Reducing energy consumption by raising energy taxes might reduce the costs of supply interruptions and increase the flexibility of U.S. foreign policy. Moreover, reduced demand for imported oil resulting from an energy tax could force foreign suppliers to absorb part of the tax through lower prices. Finally, energy taxes (by raising energy prices) would help preserve the conservation gains that have been achieved in recent years and that might otherwise be lost as a consequence of lower oil prices.

Concern has been expressed over the use of energy taxes, on several grounds. Because they would raise energy prices, these taxes would more heavily burden low-income taxpayers who spend a relatively high percentage of their income on energy. Moreover, energy taxes could have widely different effects on firms and households in different parts of the country. In addition, to the extent that the imposition of energy taxes might raise the Consumer Price Index, indexed federal outlay programs would be affected. Finally, some observers have argued that stockpiling oil is a more cost-effective way of relieving dependence on imports that would not artificially reduce current energy use by households and businesses, and that, for the rest, free markets provide sufficient incentives for resource conservation.

Five different energy taxes are considered below.

Impose Excise Tax on Domestic and Imported Oil. An excise tax on all oil--both domestically produced and imported--could raise substantial revenue. A $5-per-barrel tax would raise about $22 billion per year and would equal more than 25 percent of the current spot price of a barrel of oil or 12 cents per gallon of gasoline.

In 1981, the average cost of a barrel of oil was $35. The current spot price is under $20 and could fall considerably more in the near future. A comprehensive tax on oil of $5 per barrel would partially offset any lowering of prices to consumers, thereby preserving conservation efforts and discouraging consumption, but would still leave prices below 1981 levels. Prices (net of tax) received by domestic oil producers would decline, which could reduce domestic oil production. To the extent that a reduction in U.S. oil consumption occurred, it could result in foreign producers implicitly bearing part of the tax through lower world oil prices. In contrast, prices received by producers of alternative sources of energy (natural gas, coal) would rise, encouraging additional production from those sources.

Impose Oil Import Fee. As an alternative to a broad excise tax on all oil, the Congress could limit the tax to imports of crude petroleum and petroleum products. This type of tax was the topic of much discussion during the deliberations over the budget resolution for fiscal year 1986. An oil import fee of $5 per barrel would raise about $7 billion per year. About one-quarter of that amount would come from higher oil windfall profit taxes, since an import fee would allow the price of all domestically produced oil to increase, thereby increasing the windfall "profit" and tax on each barrel.

An oil import fee, like a tax on all oil, would serve to maintain conservation incentives by holding up the price for all imported and domestically produced energy sources. Moreover, an oil import fee could be an appropriate source of revenue for the Strategic Petroleum Reserve, insofar as the Reserve is designed to reduce the potential consequences of oil supply interruptions. Unlike a tax on all oil, however, an oil import fee would provide an incentive to increase domestic production of oil, because the fee would raise the profitability of domestic production. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased as U.S. energy sources were depleted faster.

With the spot price of oil currently under $20 per barrel, the $5 fee would still leave the total price of oil well below its $35-per-barrel price in 1981. Furthermore, if there were excess supplies of crude oil on the world market when the fee was enacted, part of the fee would be borne by foreign suppliers. One consequence of this is that an oil import fee might cause political problems with some important U.S. trading partners (though others would benefit from a fall in the world oil price). Attempts to mitigate these problems, however, by exempting imports from selected countries such as Canada, Mexico, and the United Kingdom would substantially reduce the fee's revenue potential.

Impose Excise Tax on Natural Gas. Price controls on most domestically produced natural gas were lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA), but an estimated 35 percent to 40 percent will remain regulated and subject to price controls. The average wellhead price for all gas is about $2.60 per 1,000 cubic feet, but is $1.40 for price-controlled gas. Economists generally agree that price controls lead to an inefficient allocation of natural gas. Below-market prices for some categories of gas will tend to make producers shift their production from controlled to decontrolled gas. To the extent that decontrolled gas is more costly to produce, resources are wasted from these production shifts. In addition, below-market prices encourage some consumers to use more gas than they would otherwise.

The current misallocations in the natural gas market could be substantially reduced if all gas were decontrolled. Full decontrol of all natural gas, however, could result in large windfall profits for producers of gas still under price controls. The Congress might want to tax this windfall as it did that on oil. One version of such a tax could raise $5 billion in the first full year. To the extent that windfall profits from the decontrol of gas were temporary, such a tax would provide only a short-term reduction in the deficit. Moreover, taxing the profits of gas producers could reduce any potential gain from decontrol by significantly reducing the incentive for companies to reallocate their production toward the least expensive supply sources.

An alternative that would raise revenue on a long-term basis would be a simple excise tax on natural gas, unrelated to any calculation of windfall profits. An excise tax of $1.00 per 1,000 cubic feet, for example, would raise about $13 billion annually. The current price of residential natural gas is about $7.00 per 1,000 cubic feet, so that if the tax was fully passed on to consumers, the price rise would be about 14 percent. Such an excise tax would encourage conservation of gas or conversion to oil, coal, or other fuels. To the extent that gas users shifted to oil, however, dependence on imports could increase. Moreover, while switching to coal would avoid increasing oil consumption, it might impose additional environmental costs. Therefore, a tax on natural gas alone might not be consistent with other energy policy goals. This inconsistency might be avoided by simultaneously taxing other energy sources, as well as natural gas.

Impose Additional Motor Fuel Excise Tax and Allocate Revenues to General Fund. The present federal tax on gasoline and other highway motor fuels is 9 cents per gallon. The revenue from this tax is earmarked for construction and improvement of highways, bridges, and mass transit facilities. State governments also impose gasoline taxes ranging from 7 cents to 18 cents per gallon. Compared with other countries, many of which levy taxes of well over $1.00 a gallon, the United States charges one of the lowest tax rates on motor fuel in the world.

An additional federal excise tax on motor fuels would raise about $0.9 billion per year for each cent per gallon of tax. If the tax was used to expand transportation outlays through the highway trust fund, it would not reduce the deficit; instead, this estimate assumes the proceeds would be allocated to the general fund. Because the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $1.20 in December 1985 (with further declines expected), an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced.

Beyond raising revenue, an additional excise tax on motor fuel would reduce consumption of gasoline and diesel fuel and dependence on foreign oil by encouraging people to drive fewer miles or purchase more fuel-efficient cars and trucks. The excise tax would probably not significantly affect oil consumption for other purposes, such as electricity production or home heating. Arguments against such a tax are that it would impose an unfair burden on people who commute long distances by car, compared with other users of energy, and that it would be regressive. The regressiveness of the tax, however, might be offset by small adjustments in income tax rates or by providing energy stamps for low-income people.

Impose Broad-Based Tax on All Energy. Instead of placing selective excise taxes on various types of energy, the Congress could impose a broad-based tax on all forms of energy consumption. This tax would apply to most energy sources and cover both domestic and foreign suppliers. A national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. It would probably neither decrease oil consumption as much as an oil import fee or oil excise tax of equal revenue, nor provide significant incentives for consumers to switch to forms of energy other than oil. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise over $15 billion per year in revenues. Further, because the tax would apply to all energy sources, it could raise much more revenue at a lower rate than through selective taxes.

A national energy tax could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content--in British thermal units--of the fuel (Btu tax). Depending on how the tax was structured, the relative prices of the various forms of energy could either be left unchanged or substantially altered. For example, because a dollar's worth of coal currently buys more Btus, a uniform Btu tax would raise the price of coal by a larger percentage than that of oil or natural gas. (Coal sells for about one-quarter of the price of oil per Btu.) A national tax on energy could be collected either from producers and importers, or from wholesalers.

REV-06 INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Extend DEFRA Increase of Telephone Excise Tax	0.0	1.3	2.3	2.5	2.7	8.8
Raise the Cigarette Excise Tax to 32 Cents per Pack	3.5	5.1	5.1	5.1	5.1	23.8
Increase Excise Taxes on Distilled Spirits	0.5	0.7	0.7	0.7	0.7	3.5
Raise Excise Taxes on Beer and Wine to Rate on Distilled Spirits	5.7	6.2	6.3	6.4	6.5	31.1
Index Current Cigarette and Alcohol Excise Tax Rates for Inflation	0.3	0.4	0.6	0.8	1.1	3.2

Additional revenues could be raised by extending the temporary increases in the tobacco and telephone excise taxes that were imposed in recent tax legislation, and by increasing alcohol excise taxes.

Extend DEFRA Increase of Telephone Excise Tax. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the excise tax on local and long-distance telephone service and teletypewriter exchange service to 3 percent for calendar years 1983 through 1985. The Deficit Reduction Act of 1984 (DEFRA) extended the 3 percent rate through calendar year 1987. Extending the tax beyond 1987 at the 3 percent rate would raise net revenues by about $9 billion over fiscal years 1988-1991.

Arguments for extending the tax are that it is a broad-based tax, since virtually all households have telephones, and that the cost to the government of administering the tax is low. Arguments against extension are that the tax is arbitrary, burdening households in proportion to their use of telephone services rather than income or some other standard of fairness; that it may limit expansion and innovation in the telecommunications industry; and that it is regressive if it is not offset by other changes in the tax structure.

Increase the Cigarette Excise Tax. TEFRA increased the excise tax on cigarettes from 8 cents per pack to 16 cents for the period from January 1, 1983, to September 30, 1985. The 16-cent rate was subsequently extended through March 15, 1986. (The President's budget assumes the 16-cent rate will be made permanent by the Congress; the CBO baseline forecast assumes it will expire as scheduled on March 15, 1986.) The 16-cent federal tax represents under 20 percent of the current average market price (including tax) per pack, significantly less than the 42 percent of the price that the 8-cent tax represented when it was set in 1951. Making the 16-cent rate permanent would add about $9 billion to federal revenues (net of reduced income taxes) between 1987 and 1991. Extending the 16-cent rate through fiscal year 1986 and then increasing the tax to 32 cents per pack on October 1, 1986, would raise about $24 billion (net of reduced income taxes) between 1987 and 1991.

An increase in the cigarette tax could be seen as compensation for those costs of smoking not included in the price received by sellers, such as medical costs, that society in general ultimately bears. In that sense, it would improve horizontal equity by making smokers confront the full social costs of smoking. An increase might also discourage smoking to a limited degree by raising prices, which would probably have its greatest impact on the young, thereby resulting in long-run improvements in health. On the other hand, if the increase exceeded any net costs imposed on other taxpayers by smokers, it could be regarded as discriminatory against smokers (about one-third of the population) and also objected to as regressive. (The regressiveness of the tax, however, could be offset by relatively small changes in the structure of income tax rates.) Finally, increases in the federal cigarette tax would have an adverse effect on state and local revenues from cigarette taxes and in many states would merely substitute for a planned state increase in cigarette taxes.

Increase Taxes on Alcoholic Beverages. The tax on distilled spirits was increased by DEFRA to $12.50 per proof gallon effective October 1, 1985. This marks the first increase in the tax rate on distilled spirits since 1951 when it was set at $10.50 per proof gallon. In 1951, $10.50 per proof gallon represented 43 percent of the average product price; by comparison, $12.50 per proof gallon represents 27 percent of the average current price. Increasing the tax to $15.00 per proof gallon on October 1, 1986, would raise

$3.5 billion in revenues (net of reduced income taxes) over the 1987-1991 period and still leave the tax as a percentage of average product price below that in effect in 1951. The increase in tax to $15.00 would represent roughly a 5 percent increase in the price of a typical bottle of bourbon.

Nondistilled beverages--beer and wine--were unaffected by DEFRA and are thus still taxed at the per-unit rates in effect since 1951. Moreover, beer and (especially) wine are currently taxed significantly more lightly than distilled spirits relative to both value and alcohol content. Increasing the tax rates on beer and wine to the alcohol-equivalent rate of the current tax rate on distilled spirits, effective October 1, 1986, would raise about $31 billion between 1987 and 1991. The tax on a fifth of wine, with 12 percent alcohol content, would increase by 57 cents, from 3 cents to 60 cents, and the tax on a six-pack of beer would increase by 49 cents, from 16 cents to 65 cents.

As with cigarette taxes, increased taxes on alcoholic beverages would bring the tax rates more into line with historical rates, and would help to offset the social costs of drinking (such as those from alcoholism and alcohol-related automobile accidents). On the other hand, some critics might argue that increases would make tax rates on alcoholic beverages unjustifiably high compared with the costs imposed on others by most alcohol users. In addition, as with cigarette taxes, increases may be objected to as regressive (to the extent they are not considered user charges); and increases in the federal tax rates would interfere with a tax base tapped by the states.

Index Cigarette and Alcohol Tax Rates for Inflation. When taxes are set on a per-unit basis, the tax as a percentage of value will fall as inflation boosts the value of the taxed product. As a result, inflation reduces the real burden of unit taxes over time. Indexing tax rates to the Consumer Price Index would insure that tax revenues kept pace with inflation. Indexing current cigarette and alcohol tax rates to changes in the CPI after October 1, 1986, would raise about $3 billion in net revenues over the 1987-1991 period.

Indexing of specific excise taxes would prevent inflation-induced erosion of tax receipts in a gradual and predictable manner, thereby reducing the impact of abrupt increases in unit rates on consumers, state and local governments, and businesses. On the other hand, to the extent excise taxes are regarded as inferior to income or general sales taxes as a way to raise revenue, failure to index them is one way to allow their relative burden to decline over time.

An alternative to indexing would be to convert the unit taxes to *ad valorem* taxes (set as a percentage of value); this would accomplish the same objective of tying tax revenues to price increases, although revenue would be tied to the prices of the taxed goods, not the general price level. *Ad valorem* taxes would, however, be administratively more complex because of the need to impute manufacturers' prices when the goods are sold by manufacturer-controlled wholesalers and retail outlets.

REV-07 REVISE DEPRECIATION RULES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
H.R. 3838	13.0	27.3	38.9	53.2	75.9	208.3
President's Tax Reform Proposal	12.4	24.2	32.4	43.9	53.1	166.0

NOTE: These revenue estimates are based on new depreciation systems as explained in the text. The estimates include a repeal of the investment tax credit. Both options are estimated on the basis of the current set of tax rates, not the lower rates proposed by the President and the House.

Under current law, capital assets are depreciated under schedules provided for by the Accelerated Cost Recovery System (ACRS). This system assigns each asset to one of five groups: most machinery and equipment are assigned to the three- or the five-year depreciation class; most public utility property is placed in the 10- or 15-year public utility class; and most buildings are assigned to the 19-year real property class. Equipment and machinery, but not buildings, are also eligible for the investment tax credit (ITC): assets in the three-year class qualify for a 6 percent credit; assets in the five-year and public utility classes qualify for a 10 percent credit.

This capital recovery system (consisting of the combination of ACRS and the investment tax credit) has been criticized because it favors some assets over others and because it facilitates tax shelter activities. Specifically, some critics charge that, because effective tax rates on different classes vary widely, investment decisions are driven by tax considerations and not strictly by the market, thereby resulting in an inefficient allocation of scarce capital. The table below, which shows effective corporate tax rates for several types of assets, indicates that current law significantly favors equipment over structures by taxing them at much lower effective rates.

Another line of criticism notes that taxes on the return both to machinery and equipment and to buildings are lower than taxes on ordinary income because of the acceleration of depreciation deductions. This en-

EFFECTIVE CORPORATE TAX RATES ON ASSETS

Asset Class	ACRS (years)	Real Effective Tax Rates (In percents) Current Law	ACRS No ITC	ACRS Full Basis Adjustment a/	H.R. 3838 b/	President's Proposal b/
Automobiles	3	-12.6	38.1	4.0	42.6	24.4
Computers	5	-8.5	48.7	10.8	38.5	26.8
Heavy Trucks	5	-8.0	47.2	10.2	37.1	25.7
Aircraft	5	-6.1	41.0	8.1	47.8	26.7
General Industrial Equipment	5	-4.5	34.2	6.2	46.1	27.7
Furniture and Fixtures	5	-4.2	32.6	5.8	39.0	20.3
Communication Equipment	5	-4.4	33.7	6.1	40.1	27.1
Ships and Barges	5	-3.3	27.8	4.7	42.4	27.4
Engines and Turbines	10	18.3	39.5	22.7	51.1	27.9
Electric Light and Power	15	16.0	31.9	18.9	42.9	20.1
Telephone Plant	15	16.5	32.7	19.4	43.8	20.6
Industrial Buildings	19	38.2	38.2	38.2	48.8	40.5
Commercial Buildings	19	35.3	35.3	35.3	45.7	37.5

SOURCE: Congressional Budget Office.

NOTE: Taxes are computed under the assumptions of 100 percent equity financing, a 4 percent expected inflation rate, and a real rate of return of 6 percent net of the corporate taxes. The taxpayer is a corporation with a statutory marginal tax rate of 46 percent. Taxes paid by individual shareholders on dividends and capital gains are not counted in the calculation; the tax rate is the corporate-level tax only.

Economic depreciation rates used in the calculation of these tax rates are reported in Charles R. Hulten and Frank C. Wykoff, "The Measurement of Economic Depreciation," in Charles R. Hulten, ed., *Depreciation, Inflation, and the Taxation of Income From Capital* (Washington, D.C.: The Urban Institute, 1981), p. 95.

a. For a discussion of the full basis adjustment, see REV-09.

b. Assumes a statutory tax rate of 46 percent.

courages the formation of tax shelters in real estate and equipment leasing. These tax shelter investments are often carried out by limited partnerships that create artificial tax losses for individuals through the combination of accelerated depreciation, interest deductions, and capital gains taxation of the proceeds of real estate sales.

One way to ameliorate these problems would be to eliminate the investment tax credit and alter depreciation rules so that depreciation deductions more closely resembled actual depreciation. Changes in depreciation rules to meet these objectives could be accomplished in a variety of ways. One option would be the depreciation system in H.R. 3838. Under such a system, assets would be grouped into 10 classes, depending on their useful lives. For machinery and equipment, this determination would be made according to an asset's ADR midpoint life. (The ADR midpoint life is the midpoint of an asset's depreciable life under the Asset Depreciation Range System--the depreciation system that existed prior to the Economic Recovery Tax Act of 1981.) Real property would be placed in the highest ADR class.

Under the depreciation system in H.R. 3838, assets would be assigned the following class lives:

ADR Midpoint (years)	Recovery Life Under Proposal
Less than 5	3
5 to 6.5	5
7 to 9.5	7
10 to 12.5	10
13 to 15.5	13
16 to 19.5	16
20 to 24.5	20
25 to 29.5	25
30 to 35.5	30
36+ and real property	30

The depreciation rate would be determined by use of the 200 percent declining balance method except for the longest-lived assets, which would be depreciated using straight-line only.

A revision of the depreciation system to approximate economic depreciation would improve the allocation of capital among users by reducing disparities in effective tax rates among assets, and would reduce incentives to engage in tax shelter activities. The tax rates in the table above show that the tax system would be much more neutral among different types of assets under H.R. 3838 than under ACRS with the investment tax credit. In addition, it would reduce discrimination against firms and industries (primarily firms suffering temporary losses, and start-up firms or firms with extraordinarily large capital expansion programs) that are unable to make full use of existing incentives because they lack the income or taxes from past investments required to offset newly earned deductions and credits. At current tax rates, this proposal would raise about $13 billion in 1987 and $208 billion over the 1987-1991 period.

If not accompanied by other provisions, however, such as lower corporate tax rates or relief of double taxation of corporate income, any lengthening of depreciation periods or reduction in investment credits would increase the taxation of capital income and could reduce overall business investment. Furthermore, increasing the taxation of business capital would widen the distortion that favors housing and consumer durables (currently untaxed), thereby shifting more capital into the household sector. This increased distortion could offset the improvement in efficiency resulting from the evening of tax rates. Thus, Congress may want a depreciation system that continues to encourage business investment, but in a more neutral fashion than current law.

One proposal that would maintain an effective tax rate below the statutory corporate rate, thereby continuing to subsidize domestic plant and machinery, is the depreciation system embodied in the President's tax reform proposal. This system, referred to as the Capital Cost Recovery System (CCRS), would consist of six classes of assets with tax lives somewhat longer than are now used under ACRS. (Depreciable lives would range from 4 years for short-lived property to 28 years for long-lived property.) Depreciation allowances would, however, be indexed for inflation and would be more generous than current allowances except at very low rates of inflation. Depreciation allowances would also be more generous under CCRS than those in H.R. 3838 because the latter does not provide any indexation. As with H.R. 3838, the President's proposal would eliminate the investment tax credit.

The effective tax rates under CCRS shown in the table (the President's proposal) indicate that the rates on machinery and equipment are substantially above current law rates, but well below those under H.R. 3838. (They are also below those under ACRS, excluding the ITC.) The tax rates under CCRS are generally in the neighborhood of 20 percent to 27 percent, compared with a statutory rate of 46 percent. The effective tax rates on commercial and industrial buildings under CCRS, however, are somewhat higher than under current law, but remain below the statutory rate. Overall, CCRS would reduce (but not eliminate) the disparities that now exist in taxation of machinery and equipment versus buildings and structures, and could thereby improve the allocation of business capital. These calculations indicate that CCRS would retain a substantial incentive for machinery and equipment, but would not be nearly as generous as present law. At current tax rates, this proposal would raise about $12 billion in 1987 and $166 billion over the 1987-1991 period.

REV-08 MATCH INCOME WITH EXPENSE FOR MULTIPERIOD CONSTRUCTION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	2.4	8.2	12.4	10.2	7.5	40.8

In general, taxpayers are required to calculate their taxes on an annual basis, which requires assigning all expenses and revenues to a tax year. Where the production of goods and services involves a long time between the start of production and the receipt of payment, rules are needed to allocate revenues and costs across several years. For example, the interval between the start of construction of a nuclear aircraft carrier and its final delivery to the U.S. government may be five years.

Accounting Method for Long-Term Contracts. Under current law, taxpayers can use either the "percentage of completion" or the "completed contract" method of accounting for income and expense related to long-term contracts. The percentage of completion method allows taxpayers to deduct all contract costs on a current basis, but also requires them to include as income that percentage of the contract price that those costs represent, even if no cash has changed hands. For example, if 10 percent of a contract is completed in a given year, 10 percent of the contract's final price is allocated as income for that year. This rule results in a fairly accurate annual measure of income since it requires firms to match costs with their associated income on an annual basis.

In contrast, under the completed contract method, gross income and deductions for most costs are deferred until the contract is completed. In general, the completed contract rules are more favorable to taxpayers than the percentage of completion rules because not all deductions for costs associated with the completion of a contract must be deferred--some costs may still be deducted currently--even though all receipts are deferred.

For contracts over two years in length, certain indirect costs may now be deducted currently. These include such items as marketing expenses, interest, and bidding expenses for contracts not awarded the contractor (see proposed Treasury Regulation 1.451-3). Perhaps the most important of these current deductions is that for interest. This allows contractors to borrow during the construction period, deduct the interest on a current basis, but defer the recognition of the associated income until the contract is completed. The rules for contracts of less than two years (three years for small contractors) are more lenient. In addition to the items above, certain other indirect contract costs are also allowed as current deductions. The preferences for longer-term contracts, though not as large, provide more subsidy than those for short-term contracts because the size of the tax benefit increases with a longer potential deferral.

Placing all multiperiod contracts on the percentage of completion basis would result in a more accurate annual measure of income. All expenses would be deductible on a current basis, and income would be recognized over time as the contract was completed.

Construction Period Interest. Under current law, interest related to self-constructed real property (that is, property constructed by the taxpayer for the taxpayer's own use) must be capitalized and amortized over 10 years. Interest related to the construction of all other tangible property (whether self-constructed or not) is allowed as a current deduction. For example, interest paid during the construction of heavy-duty machinery is currently deductible.

Requiring capitalization of interest on all long-lived self-constructed personal property (and real property) used in the taxpayer's trade or business (or for any activity for profit) and for all property (produced for sale by contractors) that required more than two years to produce would match interest deductions with the income the associated costs generate. Under this proposal, contractors using the completed contract method of accounting would be required to capitalize construction period interest for construction contracts over two years in length; those required to use the percentage of completion method would still be able to deduct interest on a current basis.

H.R. 3838 would require the percentage of completion method for multiperiod contracts (except for small contractors) and capitalizing construction period interest, as described above. This would raise about $2 billion in 1987, and $40 billion over five years. In contrast, the President's tax reform proposal would retain the completed contract rules, but would extend the capitalization rules for contracts of over two years to all multiyear contracts. Some contract costs would, however, remain currently deductible.

Proponents of these accounting rules (for contracts and for construction period interest) argue that they result in a more accurate measure of a taxpayer's income. They argue that costs should be matched against the income they produce; if not, opportunities for deducting current expenses and deferring income recognition can result in substantial tax avoidance. In the case of long-term contracts, this argument implies that deductions should not be allowed until income is recognized. Similarly, for self-constructed assets this implies that all costs (including interest) necessary to the production of an asset should not be deducted until that asset is placed in service and depreciated or otherwise disposed of.

Opponents of these accounting proposals argue that they are administratively more complex than current law. Also, they may impose some cash flow problems on some contractors since they would require them to pay taxes before the actual receipt of cash from final purchasers. Moreover, to the extent defense and other federal contractors are adversely affected, there may be a smaller net budgetary savings if higher outlays are necessary to compensate suppliers for higher tax payments.

REV-09 ELIMINATE INVESTMENT TAX CREDIT OR REQUIRE FULL BASIS ADJUSTMENT

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Eliminate Credit	12.1	25.0	30.9	35.7	41.2	144.9
Require Full Basis Adjustment	0.4	1.6	3.1	4.7	6.2	16.0

Under current law, taxpayers are allowed tax credits for business investments in personal property (mostly machinery and equipment). The investment credit for property with a five-year life (which includes most machinery and equipment investment) is 10 percent, while the investment credit for three-year property (mainly R&D equipment, lightweight motor vehicles, and special tools) is 6 percent. Firms are required to reduce their depreciation allowances by 50 percent of the investment tax credit; this is referred to as a 50 percent "basis" adjustment. Thus, for property receiving a 10 percent credit, firms can depreciate 95 percent of its cost (although they have effectively paid only 90 percent); for property receiving a 6 percent credit, firms can depreciate 97 percent of its cost.

For three- and five-year property, the combination of the investment tax credit and current depreciation rules is about equivalent to an immediate write-off in present-value terms (assuming a 10 percent discount rate). This implies that the expected corporate tax rate on income from new three- and five-year property is about zero. In contrast, the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) for 10- and 15-year public utility property and commercial and industrial buildings is much less generous. (Although public utility property is eligible for the investment tax credit, commercial and industrial structures are not.) Thus, the expected corporate tax rate on income from public utility property is about 15 percent and from commercial and industrial structures about 35 percent. (See the effective tax rate table in REV-07.)

Two alternatives for narrowing the disparity in effective tax rates among assets would be to require a full (100 percent) basis adjustment for the credit or to repeal the credit altogether. (The full basis adjustment would require firms to reduce their depreciation allowances by the full amount of the investment tax credit.) The full basis adjustment would raise the expected corporate tax rates on income from three- and five-year property to between 5 percent and 10 percent, depending upon the specific asset. Tax rates on income from public utility property would rise to about 20 percent; those on income from structures would remain at about 35 percent (see the effective tax rate table). Requiring the full basis adjustment would raise revenues by $0.4 billion in 1987, and $16 billion over the 1987-1991 period.

Repealing the investment tax credit would result in a further convergence in expected corporate tax rates. This change would raise tax rates on three- and five-year property to between 35 percent and 50 percent, depending on the asset. The tax rates on public utility property would rise to between 30 percent and 35 percent; tax rates on commercial and industrial buildings would remain at about 35 percent. As shown in the effective tax rate table, this option would substantially lessen the divergence in effective corporate tax rates relative to current law. Both H.R. 3838 and the President's tax reform proposal would repeal the credit. Repealing the credit for property placed in service after January 1, 1987, would raise revenues by $12 billion in 1987, and $145 billion over the 1987-1991 period. Application of more liberal transition rules, such as those in H.R. 3838, for property placed in service after the effective date could significantly reduce the revenue pickup in the first two years.

It has been argued that the current investment tax credit is necessary to encourage domestic investment in equipment and machinery, thereby increasing productivity and the international competitiveness of U.S. industry. The opposite case is that current tax law is too generous in its treatment of machinery and equipment compared with structures and inventories, and may distort decisions on investments; that is, it may lead corporations to invest too much in equipment and not enough in new plant and inventories. Requiring a full basis adjustment would partially reduce the current disparity in tax rates; repealing the credit would alleviate most of the tax distortion. (See REV-07 for changes in depreciation rules and further discussion of investment incentives.)

REV-10 REDUCE INCENTIVES FOR BUILDING REHABILITATION

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Repeal the Rehabilitation Tax Credits	0.4	1.3	1.8	2.1	2.4	8.0
Limit Credits to Historic Renovations	0.3	0.9	1.2	1.3	1.4	5.1

Current law allows large tax credits for amounts spent rehabilitating older income-producing buildings and provides rapid amortization for rehabilitating low-income housing. These measures were designed to encourage businesses to renovate their existing premises rather than relocate; encourage people to refurbish older buildings for new uses; promote the preservation of historic buildings; and increase the supply of low-income housing.

Rehabilitation tax credits range from 15 percent to 25 percent, depending on the age of the building and whether it is registered with the Department of the Interior as a historic structure. Rehabilitation of low-income housing can be amortized over a 5-year period, as opposed to the 15-year period permitted for new construction of low-income housing under the Accelerated Cost Recovery System. Repealing the rehabilitation credits would increase revenue by $8 billion over the 1987-1991 period; retaining only a 15 percent credit for certified historic renovations would save $5 billion in 1987-1991; increasing the amortization period for qualified low-income housing from 5 years to 15 years would save $0.1 billion in 1987 through 1991.

The main argument against these incentives is that they tend to divert capital from more productive uses by favoring particular investments. For example, the credits favor commercial use over most rental housing. Commercial buildings can qualify for the credit even if not in a historic district, but credits for rental housing are only available for historic buildings. In favoring renovation over new construction, the credits may encourage more costly ways of obtaining more housing and commercial buildings.

The argument for the credits is that rehabilitation of low-income housing and historic preservation may have social benefits, such as the prevention of neighborhood deterioration. The rapid amortization for low-income housing may reduce the amount of direct outlays for rent subsidy payments to poor families; the rehabilitation credit for older commercial buildings may stem the outflow of jobs from urban areas, and it discourages destruction of historically noteworthy or architecturally distinguished buildings. This latter objective, however, could be accomplished at lower cost by retaining a credit only for renovation of certified historic buildings. Preliminary surveys indicate that a 15 percent credit would be sufficient to cover the extra costs of certification and historic-quality rehabilitation. In addition, limiting the credit to historic buildings would remove the incentive to convert older rental housing to commercial use.

The President's tax reform proposal would eliminate rapid amortization for low-income housing and repeal the rehabilitation tax credits for older and historic structures. H.R. 3838 would retain rapid amortization for low-income housing, but reduce the rehabilitation tax credits to 20 percent for certified historic structures and to 10 percent for nonresidential buildings constructed before 1935.

REV-11 REPEAL PERCENTAGE DEPLETION ALLOWANCE AND EXPENSING OF INTANGIBLE DRILLING, EXPLORATION, AND DEVELOPMENT COSTS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Repeal Percentage Depletion	0.9	1.4	1.4	1.5	1.5	6.7
Repeal Expensing of Intangible Drilling, Development, and Exploration Costs	2.0	3.1	2.7	2.4	2.0	12.1
Total	3.9	6.3	5.7	5.2	4.7	25.9

NOTE: These estimates are based on CBO's baseline oil price forecast of $23.60 per barrel in 1987, rising to $27.50 per barrel by 1991. To the extent that actual prices differ from this forecast, revenues may be significantly affected.

Mineral properties, such as oil and gas wells, coal mines, or gravel quarries, are similar to depreciable assets in that they require large "up front" expenditures to produce assets that generate future income. These capital costs for mineral properties come in three types: costs associated with acquiring mineral rights and exploring for possible mineral deposits; development costs, including expenses such as those related to drilling oil wells or mine excavation; and costs for capital equipment, such as pumps or construction machinery.

In general, mineral acquisition and exploration costs may not be immediately deducted (that is, may not be expensed), but must be "capitalized" and deducted in future years. An exception to this rule allows exploration costs for hard mineral industries (such as coal or iron ore) to be deducted immediately, but recaptures them once a mine is brought into production. (Recapture involves including exploration costs as income in the year the mine begins production.) In general, these capitalized costs are deducted over time through either cost or percentage depletion. Cost depletion allows firms to deduct costs according to the percentage of estimated reserves produced each year. For example, if 5 percent of a well's remaining reserves are produced in a given year, 5 percent of the well's unrecovered depletable costs are written off in that year. The total amount of cost depletion deductions allowed over time equals the total amount of capitalized costs.

Many taxpayers are allowed the alternative of percentage depletion to compute their annual depletion deduction. Percentage depletion allows firms to deduct a certain percentage of the gross income from a property as depletion, regardless of the firm's actual capitalized costs. For example, nonintegrated oil and gas companies are allowed to deduct 15 percent of their gross revenue from their first 1,000 barrels per day of oil and gas production each year, regardless of their capitalized costs. (Integrated oil and gas producers are required to use cost depletion for recovering capitalized costs.) Hard mineral producers are also allowed to use percentage depletion at varying statutory rates. Minerals eligible for percentage depletion include coal (10 percent), uranium (22 percent), oil shale (15 percent), gold (15 percent), and iron ore (14 percent). Percentage depletion is generally considered more generous than cost depletion. Both the President's tax reform proposal and H.R. 3838 would repeal percentage depletion, except for low-producing oil and gas wells.

Mine development costs and oil and gas drilling costs are also immediately deductible, except in the case of integrated producers. Under the Deficit Reduction Act of 1984, the Congress limited expensing of producing wells for integrated oil and gas producers to 80 percent of intangible drilling costs, with the remaining 20 percent deducted over a 36-month period. The President's proposal would retain these provisions; H.R. 3838 would allow continued expensing of some drilling costs, but would require other costs to be amortized over 26 months.

The current tax treatment of mineral properties has been criticized because many of the preproduction expenses of mineral properties can be deducted faster than the value of the assets they "produce" declines. For example, drilling expenditures by oil companies produce assets (that is, producing wells) that gradually decline in value as oil reserves are depleted. The tax code, however, allows firms to deduct most of these costs in the year incurred. Moreover, percentage depletion often allows firms deductions in excess of their original investment. In some cases, percentage depletion (in present-value terms) is even more generous than immediate expensing of all depletable costs.

The result of these provisions is that mineral producers face effective tax rates that are lower than statutory tax rates and, for many producers, lower than effective tax rates on other industries. This tax advantage could be mostly eliminated by replacing the current set of provisions for mineral capital costs with a new system of cost recovery that required all expenditures on mineral rights, exploration, development, and drilling to be capitalized. Under this proposal, all producers would be allowed the option of recovering these costs through the current provisions for cost depletion or amortizing them over 10 years (using the 250 percent declining balance method, switching to straight-line depreciation after six years). Expenditures on dry holes, unproductive mines, or worthless mineral rights would, however, still be expensed. This proposal would raise about $4 billion in 1987 and $26 billion over the 1987-1991 period.

Opponents of expensing and percentage depletion argue that the inherent subsidy they provide is not needed, especially in the oil and gas industry where prices have risen sharply over the last 12 years. As a result of these subsidies, too much capital is allocated to extractive industries as opposed to other more productive uses. Opponents also argue that this is tantamount to a policy of "draining America first" and will result in greater energy vulnerability in the future. Finally, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic production of oil, other fuels, and hard minerals. Furthermore, proponents argue that because the oil and gas industry is highly risky, especially for small firms, favorable tax treatment is required so that firms can raise sufficient capital. Advocates also argue that many other forms of equipment and machinery now receive tax treatment that is at least as favorable as mineral capital investment, because of the substantial liberalization of depreciation allowances and investment tax credits. When compared with five-year ACRS property, expensing of development costs or percentage depletion may no longer provide any preferential tax advantage. Also, if account is taken of the windfall profit tax on oil, some investments in the oil industry may even be relatively disadvantaged compared with other industries.

REV-12 ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Mortgage Revenue Bonds						
Multiple dwellings	0.1	0.2	0.3	0.4	0.6	1.6
Single-family homes	0.3	0.6	0.7	0.7	0.7	3.0
Industrial Development Bonds						
Small issues	0.1	0.2	0.2	0.3	0.3	1.1
Pollution control	0.1	0.1	0.2	0.4	0.5	1.3
Other	0.1	0.3	0.6	0.9	1.3	3.2
Student Loan Bonds	a/	a/	0.1	0.1	0.1	0.3
Hospital Bonds	0.2	0.5	1.0	1.6	2.2	5.5
Total	0.8	1.9	3.2	4.4	5.7	16.0

a. Less than $50 million.

State and local governments have for many years issued bonds to finance public investments such as schools, highways, and water and sewer systems. In the past 20 years, however, these governments have issued a rapidly increasing volume of bonds to finance private-sector projects, such as shopping centers, industrial plants, and pollution control facilities. Because interest on many of these "private-purpose" bonds, like those on public-purpose bonds, is exempt from federal taxation, rates are lower. These below-market low interest rates constitute a federal subsidy of the borrowing costs of private taxpaying entities. If current law remains in effect, revenue losses from all private-purpose bonds will amount to $15.5 billion in fiscal year 1987, rising to $21.1 billion in 1991. These bonds include mortgage revenue bonds for single-family homes and multiple dwellings; industrial development bonds (IDBs), which lower the borrowing costs of private firms for a wide variety of purposes; private hospital revenue bonds; and student loan bonds.

Tax-exempt bonds are used to subsidize activities that the federal government might want to encourage, such as low-income multifamily housing. They may also, however, subsidize facilities where the arguments for additional federal assistance are weaker or nonexistent, such as private industrial plants. In addition, in many cases, tax-exempt financing merely lowers borrowing costs for investments that would have been undertaken anyway, permitting users to earn arbitrage--that is, to profit from the spread between taxable and tax-exempt rates. Even where a subsidy is warranted and effective in increasing investment in a desired activity, tax-exempt bonds are a much less efficient form of subsidy than direct subsidies because the benefits are shared between the borrower of funds and the investor in tax-exempt bonds. Supporters of tax-exempt financing argue, however, that concerns about inefficiency should not weigh heavily in situations where the Congress is unlikely to enact direct subsidy programs; while direct subsidies may be more efficient, they would prefer inefficient subsidies if the alternative is to be none at all.

Recent tax legislation has included provisions to control the growing use of tax-exempt financing for private purposes. For example, the Deficit Reduction Act of 1984 placed a state-by-state cap on the dollar volume of student loan and industrial development bonds. At the same time, however, it extended for four years the use of mortgage revenue bonds for single-family homes, which had been scheduled to expire at the end of 1983, and it extended the sunset date on small-issue IDBs used for manufacturing to December 31, 1988. Tax exemption of new small-issue IDBs used for any other purpose will expire on December 31, 1986.

Tax reform proposals further limit the use of tax-exempt financing. The President's tax reform proposal would eliminate all tax-exempt financing for private purposes. H.R. 3838, on the other hand, would retain some private-purpose tax-exempt financing, but would limit its growth by extending the state-by-state cap on dollar volume to bonds used for housing, educational facilities, and nonprofit hospitals. At present, the cap applies only to IDBs and student loan bonds. The bill would also repeal the scheduled sunset for small-issue IDBs and eliminate tax exemption for IDBs used to finance pollution control facilities, sports stadiums, and trade show and convention centers.

Mortgage Revenue Bonds. Mortgage revenue bonds provide below-market-interest financing for rental housing and single-family homes for low- and middle-income households. Each state has a limit on the amount of mortgage bonds that it can issue, which is equal to 9 percent of its average annual mortgage originations over three years, or $200 million, whichever is greater. Under current law, states and localities can substitute mortgage credit certificates for single-family mortgage revenue bonds. This program permits the states to authorize federal tax credits to home buyers for mortgages up to an amount equal to the subsidy resulting from tax exemption. If tax exemption of mortgage bonds for multiple dwellings issued after October 1, 1986, was eliminated, it would raise $1.6 billion over the 1987-1991 period. Under current law, the revenue losses from single-family mortgage bonds and mortgage credit certificates will amount to $3.7 billion in fiscal year 1987, rising to $4.0 billion in 1991. If mortgage credit certificates and tax exemption for mortgage revenue bonds were eliminated, the savings would amount to $3.0 billion over five years.

Industrial Development Bonds. IDBs include bonds for a variety of special purposes such as pollution control; airport and port facilities; industrial parks; and trade show and convention centers. They also include so-called "small issues," which may be used for a wide variety of purposes from manufacturing to farming, but cannot exceed $10 million. In 1985, small-issue sales amounted to an estimated $18.6 billion; the volume of pollution control bonds amounted to $7.0 billion; all other bonds equaled $13.1 billion.

The use of all of these industrial development bonds has been controversial. The advocates of eliminating the bonds maintain that the large business tax cuts in the Economic Recovery Tax Act of 1981 reduced the need for additional investment subsidies in general. In fact, the combination of tax-exempt financing, the investment tax credit, and accelerated depreciation results in deductions that exceed expensing for several classes of equipment, thus resulting in negative effective tax rates on some new investment. Supporters of the bonds argue that they promote economic development. Since industrial development bonds can be offered by all jurisdictions, not just economically depressed areas, however, their advantage to poorer communities in competing for new investment is largely canceled out, with the result that the bonds represent a federal subsidy to business with no clear gains for any locality. If use of the bonds was limited to economically depressed areas, $4.4 billion would be raised over the 1987-1991 period. Eliminating IDBs issued for any purpose after October 1, 1986, would raise $5.5 billion over the 1987-1991 period. Eliminating the tax exemption for small-issue IDBs only would raise $1.1 billion.

Student Loan Bonds. State agencies float student loan bonds to increase the amount of funds available for guaranteed student loans. The bonds are an attractive investment because they are among the few securities that are both exempt from taxation and federally guaranteed. In addition, the Department of Education subsidizes the interest costs of student loans directly, although the subsidy rate is reduced in half for those student loans that are financed with the proceeds of tax-exempt bonds. The volume of student loan bonds rose from $0.1 billion in 1977 to $1.4 billion in 1984, and was $1.6 billion in 1985. The federal revenue loss from these bonds is estimated at $2.0 billion between 1987 and 1991; eliminating tax exemption for bonds issued after October 1, 1986, would raise $0.3 billion over the same period. The total budgetary cost of the bonds, and the gain from eliminating them, would be less than the revenue effect because of the lower direct interest subsidy associated with their use.

One can argue that tax-exempt student loan bonds are unnecessary because private banks and the Student Loan Marketing Association (Sallie Mae) provide similar support at the same cost to students without tax-exempt financing. In this view, student loan bonds merely provide arbitrage profits for state authorities. States argue, however, that private market financing has been inadequate and that the additional federal subsidy conveyed by tax-exempt student loan bonds widens accessibility to higher education.

Hospital Bonds. Tax-exempt bonds issued by nonprofit hospitals will account for a revenue loss of $2.8 billion in 1987, rising to $5.0 billion in 1991. Advocates of the bonds maintain that they lead to lower hospital costs; those who support eliminating the bonds question the need for any subsidy when the supply of hospital beds seems to be adequate. Eliminating the subsidy for bonds issued after October 1, 1986, would raise $5.5 billion over the 1987-1991 period.

REV-13 ELIMINATE SPECIAL CAPITAL GAINS TREATMENT FOR TIMBER, AND FOR COAL AND IRON ORE ROYALTIES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1990	1989	1991	Cumulative Five-Year Addition
Timber Income	0.3	0.7	0.7	0.8	0.8	3.3
Coal and Iron Ore Royalties	0.1	0.1	0.1	0.1	0.2	0.7

The present tax code does not generally allow capital gains treatment for income from the sale or exchange of business inventories or the normal output of a business. In an exception to the standard treatment, some of the income associated with the production of timber, coal, and domestic iron ore, which would otherwise be taxed as ordinary income, is subject to special provisions that allow it favorable capital gains treatment.

Opponents of this special treatment argue that it reduces economic efficiency by causing more timber to be cut than if production were market-determined, and by distorting choices about the ownership of natural resources. They point out that timber grown for the purpose of producing lumber or paper is no more a capital asset than wine and whiskey, which must be aged to achieve their full market value but are not treated as capital assets under current law.

Proponents of the special capital gains treatment of timber argue that timber producers should be given the same treatment available to farmers or suburban homeowners whose fields or homes bring higher prices because of their windbreaks or shade trees. (The value of a farm or house is increased by its trees, and the seller can claim capital gains treatment for the entire increase in value.) If capital gains treatment was ended for timber, but retained for land, new rules would be necessary to determine when the gain from selling land with trees on it should be taxed as capital gains and when it should be taxed as ordinary income because the seller is in the business of timber production. While these rules would make the tax law more complex, there would also be some offsetting reduction in complexity because no need would exist for rules to distinguish between income from timber growing (which is currently treated as capital gains) and ordinary income from logging and manufacturing.

Proponents of special incentives for timber argue, furthermore, that market forces alone will not spur sufficient timber growing, because the unusually long production process makes it more risky than other investments. They also hold that special treatment of timber income is needed to promote development and conservation of domestic timber resources. The goals of conservation and an assured supply of timber, however, might be achieved more efficiently with direct incentives for planting and conservation of timberlands. Finally, one difficulty in eliminating the present tax-favored status is that owners of timberland would suffer large losses, since the present tax benefits have been capitalized into land values.

The provisions allowing capital gains treatment for royalties from coal and domestic iron ore production are exceptions to the general rule that royalties are ordinary income taxable at regular rates. Without special treatment, owners of coal and iron ore properties might sell their land to get capital gains rates. Repeal of these provisions would end special subsidies available for these two minerals and would equalize treatment between owners who develop their own properties and those who sell the rights.

The President's tax reform proposal would repeal the capital gains treatment of royalties from timber, coal, and domestic iron ore, and would phase out the special capital gains treatment of timber over five years. H.R. 3838 would allow capital gains treatment for timber production and cutting by individual taxpayers, but not by corporations. The capital gains treatment of royalties from timber, coal, and domestic iron and steel would be gradually phased out. The estimates shown above are for complete repeal for both individuals and corporations effective January 1, 1987.

REV-14 ELIMINATE PREFERENCES FOR FINANCIAL INSTITUTIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities	0.1	0.3	0.3	0.3	0.3	1.3
Repeal the Deduction for Excess Bad-Debt Reserves	0.5	0.6	0.4	0.6	0.7	2.8
Treat Credit Unions Like Other Thrift Institutions	0.1	0.2	0.2	0.2	0.3	1.1
Repeal the 20 Percent Deduction for Taxable Income from Life Insurance Activities and the Small Life Insurance Company Deduction	1.0	1.7	1.9	2.1	2.2	8.9
Repeal Preferences for Property and Casualty Insurance Companies	0.3	0.6	1.5	2.1	2.5	7.0

Banks, thrift institutions, and life insurance companies receive certain tax preferences that are not allowed other businesses. Additional revenues could be raised by eliminating or reducing such preferences. All of these possible changes would tend to place different financial institutions on a more equal footing, and to result in tax treatment more closely resembling that of other businesses. They might also have negative effects, since each special provision was originally enacted to encourage a particular activity that might be discouraged by repeal.

Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities. Individuals and businesses are generally allowed to deduct from their taxable income interest charges paid on debt incurred in producing taxable, but not tax-exempt, business income. In an exception to this general treatment, banks are allowed to deduct interest payments made to depositors and other lenders even when their funds are used to finance the purchase of tax-exempt securities. One result is that banks can often escape taxes entirely by offsetting tax-free income with deductible costs. This special exception was restricted to 85 percent of the previously allowed deduction in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and to 80 percent in the Deficit Reduction Act of 1984 (DEFRA). Even with this restriction, banks have a unique tax benefit--a tax deduction equal to 80 percent of the interest cost of financing tax-exempt securities. Elimination of the interest deduction for bank holdings of tax-exempt securities would increase federal tax revenues by $1.3 billion during the 1987-1991 period. One consequence of further limiting this deduction is that tax-exempt securities would become less attractive to commercial banks. This would narrow the market for such securities and therefore could raise borrowing costs to states and localities. In addition, to the extent it raised tax-exempt interest rates, it would increase the net gain to upper-income individuals from the availability of tax-exempt securities.

Repeal the Deduction for Excess Bad-Debt Reserves. Most businesses are allowed to deduct reserves for bad debts only to a "reasonable" extent determined by their actual experience. In an exception to this general rule, banks and thrift institutions are allowed a tax deduction for bad-debt reserves in excess of the amount they actually experience. These deductions are permanent; there is no provision to recapture them if repayment experience proves more favorable. Under current law, banks will be allowed a deduction for bad-debt reserves only until the end of 1987. The deduction is currently limited to 0.6 percent of total loans. For thrift institutions--savings and loan associations and mutual savings banks--the deduction may be as high as 40 percent of their taxable income if they make a specific proportion of their loans (82 percent for savings and loans, 72 percent for mutuals) for real estate, and if they meet other conditions. These deductions were limited to 85 percent of the amount of the bad-debt reserve in excess of actual experience by TEFRA, and to 80 percent by DEFRA.

If all financial institutions were prohibited from taking excess deductions after January 1, 1987, revenue gains would amount to $2.8 billion from 1987 through 1991. Without the excess bad-debt reserves deduction, thrift institutions might be less willing to invest in relatively risky mortgages. At present, however, the amount of excess reserve allowed is not related to the riskiness of an institution's loans.

Treat Credit Unions Like Other Thrift Institutions. Before 1951, savings and loan institutions, mutual savings banks, and credit unions were not subject to federal income taxes, because they were regarded as operating for the sole benefit of their members. Since 1951, only credit unions have remained tax-exempt. Financial deregulation, however, has blurred the distinction between credit unions and other financial institutions, thereby lessening the rationale for special treatment.

Repeal or Scale Back Special Deductions for Life Insurance Companies. The taxation of life insurance companies has undergone a major restructuring that started in TEFRA and was completed in DEFRA. Part of this restructuring was a compromise about the level of taxes that the life insurance industry should be expected to pay. This compromise resulted in the provisions of DEFRA that allowed all life insurance companies to deduct 20 percent of their otherwise taxable income from life insurance products, and created a special small-company deduction for small life insurance companies (generally those with assets of less than $500 million). The small-company deduction is 60 percent of taxable income up to the first $3 million, and a lesser percentage of income over $3 million, phasing down to zero at $15 million of income. (Use of the small-company deduction reduces the base for the regular 20 percent deduction.) Repealing these special provisions would increase federal revenue from the life insurance industry without requiring another major change in the tax structure of the industry. An additional argument for repealing the small-company deduction is that stability and financial security are such basic requirements of the life insurance business that it may not be in the public interest to encourage small companies.

Repeal Preferences for Property and Casualty Insurance Companies. Under current law, property and casualty (P&C) companies are allowed to deduct additions to reserves from current income for future claims without discounting for growth in the value of those reserves between the time the deduction is taken and the time the claims are paid, and without any future adjustment to include in taxable income reserves that turn out to be excessive. In addition, mutual P&C companies are allowed to take specified deductions for a Protection Against Loss (PAL) account, which does not actually have to be funded. The PAL account provides a tax deferral, partly indefinite, and partly for no more than five years. P&C insurance companies' dividends and similar distributions paid to policyholders are treated as deductible price rebates rather than taxable income, even though dividends to policyholders of mutual companies are partly distributions of earnings to the companies' owners.

Federal revenues from the P&C insurance industry could be increased, and the tax code simplified, if the tax treatment of P&C insurance companies was made more equal to the treatment of life insurance companies and other companies that offer similar products, or that self-insure. The revenue estimate provided above includes the effects of changes, beginning on January 1, 1987, that would base deductible reserve accounts on estimates of the timing of future claim payments and the companies' after-tax return on investment assets, with adjustments to income once the claims were paid to account for differences between payments and associated liabilities. It also includes the revenue gain from repealing the PAL account, and applying to the policyholders' dividends of mutual P&C insurance companies the limitations that currently apply to those of mututal life insurance companies.

All of these changes were included in the President's tax reform proposal. H.R. 3838, in contrast, includes some but not all of these proposals. It would repeal the interest deduction for bank holdings of most tax-exempt securities and the bad debt deduction for commercial banks with more than $500 million of assets. For thrift institutions, both the bad-debt reduction and the percentage of qualified assets needed to make it available would be reduced. Credit unions, however, would remain tax-exempt. The special life insurance company deduction would be repealed, and the small life insurance deduction would be reduced. Loss reserve deductions of P&C companies would be limited if they invested in tax-exempt securities, and the ability to use loss reserve deductions to reduce taxes on non-P&C income would be restricted.

REV-15 RESTRICT USE OF THE CASH METHOD OF ACCOUNTING

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.4	1.0	1.1	1.1	1.2	4.8

With the cash method of accounting, a receipt is included in income when it is actually received, and expenses are deducted when they are actually paid, except for depreciation deductions. The cash method is not permissible for most accounting purposes because it does not reflect changes in accounts receivable and payable or in the size of inventories, which are integral parts of a complete accounting of income in any given period. Under the generally used accrual method of accounting, a receipt is included in income when all the events that determine the right to receive it have occurred, and an expense is deducted when all the events that determine the liability and its amount have occurred.

Under present law, most service industries and farms may use the cash method for tax purposes. The use of the cash method of accounting by some taxpayers, while others employ the more common accrual basis, can lead to a mismatching of income and deductions when the cash-method taxpayer provides a service (or farm product) to an accrual-method taxpayer. The mismatching occurs because the accrual-method taxpayer deducts the liability when it has been established, while the cash-method taxpayer is able to defer reporting the income from the same transaction until the cash payment has been received. The effect of this is to reduce federal revenues.

The cash method of accounting for tax purposes could be allowed only for businesses that averaged less than $5 million annual gross receipts over the three most recent years, and that do not regularly use any other accounting method. If this restriction took effect on January 1, 1987, but taxpayers were allowed to spread the adjustment proportionately over the next six years, it would increase federal revenues by about $5 billion over the 1987-1991 period.

Because cash-method accounting for tax purposes is relatively simple, many argue that it is justified for small businesses, which may find the accrual method complicated. Under current law, however, cash-method accounting for tax purposes is also available to banks and other businesses that already use the accrual method for financial accounting purposes, and to large service organizations that would not be unduly burdened by an accrual accounting requirement, such as accounting, law, and advertising firms.

The President's tax reform proposal would restrict use of the cash method of accounting, as described above. In contrast, H.R. 3838 would allow individuals, professional service corporations, partnerships of individuals or professional corporations, and Subchapter S corporations to continue to use the cash method for tax purposes, but would require other businesses with gross receipts over $5 million to use the accrual method. This proposal would increase federal revenues by $3.5 billion between 1987 and 1991.

REV-16 REPEAL THE DIVIDEND EXCLUSION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.2	0.6	0.6	0.7	0.7	2.8

Under current law, taxpayers may exclude from their adjusted gross income (AGI) up to $100 of qualified dividends from corporate share ownership ($200 for joint returns). Repeal of the exclusion effective January 1, 1987, would raise almost $3 billion in the 1987-1991 period.

The exclusion encourages taxpayers to invest in stocks until they have $100 or $200 of dividends, but provides no incentive to invest further. Repeal would have little disincentive effect because 99 percent of dividends go to people receiving more than these limits. Furthermore, encouraging widespread holdings of small amounts of stock is not necessarily desirable because stocks are a risky investment for small savers. An argument against eliminating the exclusion is that it provides some offset against double taxation of corporate dividends.

Both the President's tax reform proposal and H.R. 3838 would repeal the dividend exclusion, but would also allow corporations a 10 percent deduction for dividends paid, to reduce the double taxation of corporate income. Under H.R. 3838, the corporate dividend deductions would be phased in over 10 years, while the President proposed that it take effect on January 1, 1986.

REV-17 REPEAL THE TAX CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	2.1	1.4	0.7	0.5	0.0	4.7

Employee Stock Ownership Plans (ESOPs) are employee benefit plans to which the employer contributes the firm's stock, or cash to purchase its stock. The stock is held in a tax-exempt trust and neither the stock nor its dividends are taxable to the employee until distributed. An employer whose ESOP meets certain requirements can claim a credit for the full contribution, up to 0.5 percent of covered wages. The ESOP tax credit was first enacted in 1975 for a two-year trial; it has since been extended and modified several times and is now due to expire in 1988. Both the President's tax reform proposal and H.R. 3838 would repeal the credit. Repealing it as of October 1986 and making ESOP contributions deductible like most other compensation would increase revenues by almost $5 billion over the 1987-1991 period.

The purpose of the tax credit is to encourage corporations to set up and contribute to ESOPs. ESOPs with large stock holdings could broaden the ownership of corporate wealth, supplement retirement income, and strengthen political support for private enterprise. In addition, because ESOPs give employees an ownership interest in their firms, it is argued that ESOPs may improve employee motivation and raise productivity.

One objection to the tax credit is on grounds of equity. Through the tax credit, the government in effect buys stock and gives it to trusts for particular individuals. The stock gifts are unavailable to others, such as the self-employed and employees of unincorporated or nonprofit businesses. Another objection is that the credit could encourage employees to place too large a share of their wealth in the employer's stock, thereby exposing them to greater risk both as employees and as investors if the company performed poorly. In contrast, other benefits, such as pensions, which invest in a diversified portfolio, provide less risky means of accumulating savings for retirement. Finally, if employee stock ownership improves productivity, employers are likely to encourage it without a tax incentive.

REV-18 REPEAL 401(k) PLANS OR LOWER THE MAXIMUM CONTRIBUTION

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Repeal 401(k) Plans	1.9	4.2	4.9	5.9	7.0	23.8
Limit Contributions to $7,000 per Year	0.7	1.4	1.4	1.6	1.9	7.0

Section 401(k) of the Internal Revenue Code permits employers to operate profit sharing plans to which employees may contribute through salary reduction or from bonuses. These so-called "elective" amounts receive the same tax advantages as employer pension contributions and IRA contributions. Employers often supplement elective amounts with matching and other contributions. In these plans--generally called cash or deferred arrangements (CODAs)--all contributions for an employee cannot exceed the lesser of 25 percent of salary or $30,000, and all contributions to the plan cannot exceed 15 percent of total payroll. Withdrawals are precluded before age 59½ or retirement, except for disability, death, separation from service, or hardship. Contribution rates of the higher paid one-third of workers cannot exceed those of other workers by more than specified amounts.

CODAs are new and rapidly growing. They were first authorized in 1978; regulations governing them were published in late 1981. About 1.8 million persons contributed in 1983; about 5 million contribute now, and 12 million are projected to contribute by 1990. Repeal of CODAs would raise about $24 billion from 1987 through 1991.

One argument for repeal is that CODAs allow tax deductions for some saving that would take place anyway. For example, many CODAs appear to be a redesign of previously existing employer thrift plans. Second, because CODAs are new, most people do not have them. As a result, repealing CODAs would be less disruptive to retirement plans than substantial changes elsewhere in the pension system. Finally, if the Congress desired to expand tax-favored saving for retirement, greater equality of opportunity could be achieved by raising the IRA limit instead of allowing

CODAs. CODAs are available only to those whose employers offer the plan, while IRAs, in contrast, are available to all persons with earnings.

Proponents of CODAs argue that they are more effective than IRAs in encouraging retirement savings by middle- and lower-income employees because special rules make the contributions of the highest-paid conditional on the amounts contributed by the rank and file. As a result, some argue that employers are encouraged to subsidize contributions by the rank and file in the form of matching and other contributions.

Some advantages of CODAs could be retained with a smaller revenue cost by imposing separate limits on CODA contributions and on combined contributions to a CODA and an IRA. H.R. 3838 would impose a $7,000 CODA limit, with a dollar-for-dollar reduction in the $2,000 IRA limit for elective contributions to a CODA. Under this offset, a person contributing $1,500 to a CODA, for example, could contribute no more than $500 to an IRA. If made effective on January 1, 1987, this proposal would raise $0.7 billion in 1987 and $7 billion between 1987 and 1991.

REV-19 DECREASE MAXIMUM LIMITS ON PENSION CONTRIBUTIONS AND PENSION BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Decrease Limits to $60,000 and $15,000	0.6	1.7	1.9	2.2	2.4	8.7

Employers can make contributions to qualified pension and profit-sharing plans on a tax-favored basis. Currently, employers cannot contribute annually more than 25 percent of compensation or $30,000 per employee to defined contribution plans, and they cannot fund defined benefit plans that will result in annual benefits above 100 percent of wages or $90,000 per employee. (Defined benefit plans specify the pension to be received, usually as a percentage of salary, while defined contribution plans specify the annual contribution, usually as a percentage of salary.) The limits are scheduled to be indexed for inflation starting in 1988.

H.R. 3838 would decrease the defined benefit limit for 1986 to $77,000, with indexing of that limit to resume in 1988 (reflecting inflation after 1986). It would also decrease the defined contribution limit to $25,000, with indexing of that limit to begin again when it equals 25 percent of the defined benefit limit ($19,250 in today's terms). If effective January 1, 1987, this proposal would raise $2.2 billion between 1987 and 1991. If, instead, the defined benefit limit was lowered to $60,000 and the defined contribution limit to $15,000 in 1986, with indexing of both limits to resume in 1988 (reflecting inflation after 1986), the revenue pickup would be about $9 billion between 1987 and 1991.

Private pensions of $60,000 per year and pension contributions of $15,000 per year are more than adequate to meet average retirement needs. Furthermore, Social Security benefits are almost always received along with private pensions. Maximum Social Security benefits for a couple in 1984 were over $12,000. Individual Retirement Accounts (IRAs) are also available for supplementing employer pensions. Those persons most likely to be affected by a reduction in pension limits are the most likely to use IRAs. Three out of five taxpayers with incomes over $50,000 contribute to IRAs, compared with one out of five of all taxpayers. Thus, the present limits allow very-high-income people to defer and shelter income beyond amounts many would regard as necessary to provide a reasonable amount of retirement security. Lowering the limits, however, may reduce private saving.

REV-20 REPEAL THREE-YEAR BASIS RECOVERY RULE FOR CONTRIBUTORY RETIREMENT PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.8	2.2	2.8	2.9	2.9	11.6

Payments received from tax-qualified pension plans can have up to three possible components: employee's contributions, employer's contributions, and investment income accrued under the plan. When a retiree receives a payment, the component drawn from his or her own contributions (called the basis) is generally not subject to tax because those contributions usually were made from after-tax income. The general rule for deciding how much of each pension payment should be included in adjusted gross income is that the tax-exempt share should equal the ratio of the employee's basis to the expected total value of his annuity (payments over his expected life) at the time payments begin. This general rule is not followed when three years' worth of payments equal or exceed the employee's basis. In that case, no tax is due on payments until they exceed the employee's basis, after which they are fully taxable.

The three-year rule makes it more likely that annuitants will recover their contributions (or basis) before death. The current recovery rules, however, have been criticized as inequitable. First, the three-year rule is arbitrary, especially with respect to participants whose benefits exceed the basis just beyond the cutoff date. Second, regardless of which rule is applied, if distributions stop before annuitants have recovered their entire basis tax free, there is no carryover deduction to their estate. Both the President's tax reform proposal and H.R. 3838 would repeal the three-year rule, use standardized recovery periods, and allow a carryover deduction for any unrecovered basis. Repealing the three-year rule for pensions that begin payments after January 1, 1987, would raise almost $12 billion between 1987 and 1991.

The proposed shift to standard recovery periods would eliminate the acceleration of recovery that the current three-year rule causes, thus increasing revenues in the immediate term. This gain in revenues would be partially offset in later years, however, because annuitants would also exclude some benefits in later payment years (under the general rule) that would be included under current law.

A shift in current rules might harm contributory plan participants who are close to retirement, especially those who have taken the three-year rule into account in their planning. To avoid abrupt disruptions in expectations, a more gradual transition may be desirable. One possibility might be to permit a more limited form of accelerated recovery for the next several years; for example, one year of full tax-free recovery and use of the general rule for whatever unrecovered amounts might remain. A gradual transition would not raise as much revenue as a straight repeal of the three-year rule, but might be an appropriate adjustment.

REV-21 TAX A PORTION OF NONRETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Tax Some Health Insurance Premiums			(See ENT-01)			
Tax Life Insurance Premiums						
Income tax	1.5	2.3	2.4	2.5	2.6	11.3
Payroll tax	0.5	0.6	0.7	0.7	0.8	3.3
Disallow "Cafeteria" Plans						
Income tax	0.6	1.6	2.3	3.0	3.7	11.2
Payroll Tax	0.2	0.7	1.0	1.4	1.7	5.0

Some employer-paid, nonretirement fringe benefits are excluded from the income and Social Security tax bases even though they constitute current compensation to employees. This exclusion results in substantial revenue losses. For employer-paid health and life insurance premiums alone, the revenue loss will be about $29 billion in income tax revenues and $10 billion in payroll tax revenues in 1987. Moreover, the revenue loss from this exclusion is growing as employees seek to increase the percentage of total compensation that is received tax free. This continuing erosion of the tax base will mean that tax rates on remaining income must be increased to raise the same revenues.

Tax-free benefits also include employer-paid dependent care, which represents revenue losses of under $100 million per year through 1991, and miscellaneous benefits such as employee discounts, meals provided on premises for the convenience of the employer, benefits provided at no additional cost to the employer, *de minimus* fringe benefits, and on-premises athletic facilities. The exclusion of some fringe benefits expired on December 31, 1985. These benefits are legal service plans, transportation (van pools), and educational assistance.

Strong equity arguments exist for taxing fringe benefits. At present, a taxpayer receiving no fringe benefits pays more tax than another with the same total income but a larger share in fringe benefits. The benefits of the exclusion are greater for those with higher incomes for two reasons: these taxpayers tend to receive more fringe benefits and they face higher marginal tax rates, making the exclusion worth more to them.

Arguments against the exclusion can also be made on the basis of efficiency. Employees may bargain for tax-free benefits that they would not be willing to pay for out of after-tax income, thereby leading to overconsumption of the tax-free services. For example, employer-paid health insurance plans may have contributed to the strong growth in demand for health care, which may have contributed to recent sharp rises in health care costs.

An equity argument can be made for retaining a partial exclusion. A taxpayer with an all-cash income may have a greater ability to pay taxes than one with the same total income receiving a large percentage of income as employer-paid benefits, since the employer-paid benefits may not be worth as much to him or her as an equal dollar amount of cash wages. On the other hand, if the exclusion was eliminated, employees might insist on receiving cash instead of benefits.

The measurement of some fringe benefits for purposes of taxation presents administrative problems. Assessing the value of some benefits can be very difficult; for example, some airlines provide employees with reduced-fare or free trips where the cost to the carrier of servicing one extra passenger is essentially zero. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected. The inclusion of employer-paid health insurance and life insurance premiums in the tax base, on the other hand, would create only minor administrative problems. The premiums paid to each employee could be reported on the employee's W-2 form, and withholding computed as it is for other taxable income (this is already done for some life insurance premiums, as noted below). In contrast, the measurement of insurance values is more difficult when benefits are provided directly, as when employers provide medical care or reimburse employees for medical costs incurred (under self-insurance plans).

Tax Some Employer-Paid Health Insurance Premiums. The present exclusion for employer-paid health insurance premiums has been criticized as particularly inequitable. The exclusion is not currently available to the self-employed. Further, qualified health insurance plans (except self-insured medical reimbursement plans) may tilt benefits primarily to top management (other fringe benefits are governed by nondiscrimination rules to curb such practices). In addition, overuse of medical insurance may have led to expanded use of health care services and, thus, driven up prices for all taxpayers--not just for recipients of tax-free health insurance coverage.

The President's tax reform proposal would include in taxable income the first $10 per month (for single coverage) or $60 per month (for family coverage); H.R. 3838 would retain the current law exclusion for health insurance benefits. Two proposals to tax some employer-paid health insurance premiums are described in ENT-01.

Tax Employer-Paid Life Insurance Premiums. Employer-paid group term life insurance premiums are currently excluded from taxable income, but the exclusion is limited to the cost of the first $50,000 of insurance, and nondiscrimination rules apply. The exclusion is not available to the self-employed. Repeal of this exclusion would add $1.5 billion to income tax revenues and $0.5 billion to payroll tax revenues in 1987. Over the period 1987-1991, repeal would yield about $11 billion and $3 billion, respectively.

A problem may exist with taxing employer-paid life insurance because many employers provide death benefits under pension plans as a substitute for life insurance. Employer contributions to pension plans are income tax-deferred (and the first $5,000 of death benefits paid are tax-exempt) and are exempt from the payroll tax. If only employer-paid life insurance plans were made taxable, employers might choose to offer less life insurance and larger pension plan death benefits instead.

An alternative to repeal would be to reduce the limit on the exclusion. By reducing the limit from the cost of $50,000 of insurance to the cost of $30,000, about $10.5 billion in revenue would be raised in the 1987-1991 period.

Both the President's tax reform proposal and H.R. 3838 would retain the current law exclusion for life insurance benefits.

Disallow "Cafeteria" Plans. One vehicle for providing a range of employer-paid fringe benefits is a so-called cafeteria plan, under which employees may choose between taxable and nontaxable fringe benefits. The Deficit Reduction Act of 1984 restricted the benefits allowable under such plans. At present, a cafeteria plan may allow a choice of cash, employer-paid group term life insurance, disability insurance, accident and health insurance, dependent care benefits, and contributions to cash or deferred compensation arrangements (usually called 401(k) plans).

Cafeteria plans cause a revenue loss only because the plans provide benefits that are tax-exempt or tax-deferred. To the extent that the separate tax preferences for these benefits were repealed, allowed to expire, or limited as described above, both the benefits of cafeteria plans and the associated revenue losses would be reduced.

As long as the preferences remain in force, however, cafeteria plans pose equity problems similar to the tax preferences for fringe benefits when provided separately. Cafeteria plans may be a more efficient way of providing these benefits, however, because taxpayers are not required to accept benefits they do not need--they may choose cash instead. On the other hand, by expanding the availability of the tax preferences and allowing some taxpayers to convert taxable cash compensation into tax-preferred forms of income, cafeteria plans exacerbate the efficiency problems posed by those preferences.

The annual revenue loss from cafeteria plans is projected to grow at a rapid rate, from an estimated $1.4 billion in 1987 to $5.4 billion by 1991. Repeal of cafeteria plan provisions, while maintaining the current tax status of separate fringe benefits, would raise about $16 billion between 1987 and 1991.

REV-22 TAX CASH ALLOWANCES AND THE RENTAL VALUE OF HOUSING PROVIDED TO PERSONS IN THE UNIFORMED SERVICES AND THE CLERGY

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Tax All Allowances	1.7	2.5	2.6	2.8	2.9	12.5
Limit Homeowners' Interest Deductions	0.1	0.3	0.4	0.3	0.4	1.5

In general, the tax code treats all compensation in cash or in kind as taxable unless it is explicitly excluded. Thus, for example, an employer allowance for housing is taxable, as is the value of housing provided on the employer's premises (unless the housing is provided for the benefit of the employer and acceptance of the housing is a requirement of the job). People in the uniformed services and the clergy who live in private housing, however, receive tax-free allowances for housing. Some others in the services and the clergy choose to live on site even though they are not required to, and they are not taxed on the rental value of the housing services they receive. Finally, people in the military also receive small amounts of other tax-free allowances, primarily the subsistence allowance. Taxation of all cash allowances and the rental value of some housing provided for the uniformed services and the clergy would raise about $12 billion between 1987 and 1991.

Advantages of the proposal are clearer budgeting of costs and greater tax equity. Federal budgeting would be clarified by making the full cost of employees in the uniformed services more apparent in the budgets of the uniformed services. At present, a portion is hidden in tax subsidies. Tax equity would be enhanced by taxing recipients of allowances according to their ability to pay. When allowances are tax free, all recipients pay the same zero rate. When they are taxable, those with greater ability to pay--because of extra earnings from a spouse, fewer dependents, or greater amounts of nonwage income--pay a higher rate.

Disadvantages of the proposal are the possible changes in the military work force and difficulties in valuing on-site housing. Raising the tax burden on people in the uniformed services may encourage some of them to leave and discourage others from signing up. Increasing pay to maintain the services at their present size and quality could more than offset the federal savings from taxation, thereby raising the federal deficit. This increase might occur because the tax preference, unlike higher pay, triggers a subsidy by many states in the form of corresponding exemptions from state income taxes. The complexity of measuring the value of housing provided by the employer could be avoided by including only cash housing allowances in the tax base. Such a limit, however, would encourage the uniformed services and churches to build more on-site housing even where off-site housing was feasible and less costly.

An alternative to taxing all special allowances would be to limit the generally available mortgage interest and property tax deductions to amounts in excess of any tax-free housing allowance. Currently, a homeowner receiving a tax-free housing allowance can deduct all interest and property tax payments on the home even though the allowance provided to pay for the home is untaxed. In the proposal, for example, a person with a $6,000 tax-free housing allowance and $7,000 in interest and taxes on a home would be allowed to deduct only $1,000. If the person had $5,000 in interest and taxes on a home, nothing would be deductible. The proposal would raise $1.5 between 1987 and 1991.

This alternative would effectively eliminate the tax-exemption of housing allowances for those with mortgage interest and property tax deductions equal to or greater than the tax-free allowance. As a result, the limit would improve equity between these persons and mortgagees outside the military and clergy who must pay tax on all of their cash compensation. On the other hand, service personnel and clergy with mortgage interest and property tax deductions less than their allowance would still retain a partial tax exemption, and those with no homeowner deductions would retain the full tax exemption. Thus, the limit would substantially reduce the generally available tax incentive for homeownership for those in the services and clergy who must obtain a mortgage to buy a home. Because renters would be unaffected, however, it would not necessitate as large an increase in military pay to attract the same personnel as would full taxation of housing allowances, and would probably result in net budgetary savings.

Revenue Ruling 83-3 will limit the clergy's mortgage interest and property tax deductions to the excess above any tax-free allowance, effective January 1, 1987. The limit could be extended to the military. H.R. 3838, however, would override this ruling by providing an explicit full deduction of mortgage interest payments for the clergy and uniformed services.

REV-23 RESTRICT DEDUCTIONS FOR BUSINESS ENTERTAINMENT AND MEALS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Disallow Deductions for Business Entertainment and Limit Deductions for Business Meals	0.5	1.1	1.4	1.7	2.1	6.7
Limit Deductions to 50 Percent for Business Entertainment and 75 Percent for Business Meals	1.7	3.2	3.8	4.4	4.9	18.1
Limit Deductions to 80 Percent for Business Entertainment and Meals	1.4	2.6	3.1	3.5	3.8	14.4

In general, the tax code allows deductions for expenses necessary to earn income, including expenses for business entertainment and meals. The code does not usually allow deductions for costs of personal consumption. Unlike many other business-related expenses, it is very difficult to distinguish between meal and entertainment expenses required for business purposes (which should be deductible) and those that give rise to personal consumption (which should not reduce tax liabilities). For example, theater and football tickets, country club dues, and parties or meals at expensive restaurants may all be deductible as business expenses under current law. Restricting these deductions as described below would add about $18 billion to revenues in 1987 through 1991.

Elimination of the deduction for business entertainment has been proposed on grounds of both equity and efficiency. Some people argue that it is not equitable to permit a few taxpayers to deduct expenses for items such as football tickets, while most people must pay for them with after-tax dollars. Another argument is that the deduction encourages more spending on entertainment than would occur if these activities were not subsidized by the tax system, and that this may have increased the prices of some forms of entertainment for all attendees. Limiting the deduction for business meal expenses has been proposed on the grounds that many of these expenses are greater than necessary to conduct business.

The President's tax reform proposal would disallow most deductions for business entertainment expenses (excepting expenses for items taxed as compensation to beneficiaries, recreational expenses for employees, and items made available to the general public). It would limit deductions for a business meal to $25 times the number of participants plus half of the remaining expenditures for the meal. If made effective January 1, 1987, this proposal would raise about $7 billion in revenues from 1987 through 1991.

Limiting the deduction for business meals as in the President's proposal would probably reduce the number of meals served at expensive restaurants, but would not significantly affect most restaurants. One difficulty with the $25 base of the limit is that it does not have the same value to all taxpayers across the country. Restaurant prices, for example, are generally higher in large urban areas than in smaller cities.

The House Committee on Ways and Means staff proposal of 1985 would have allowed a deduction for 50 percent of business entertainment expenses and 75 percent of business meal expenses. If made effective January 1, 1987, this proposal would raise about $18 billion from 1987 through 1991. The House enacted instead, in H.R. 3838, a proposal to allow a deduction for 80 percent of all business entertainment and meal expenses. If made effective January 1, 1987, this proposal would raise about $14 billion through 1991.

Eliminating or limiting business meal and entertainment deductions could have some negative effects on the restaurant and entertainment industries because a large fraction of meals and tickets to sporting and theater events is purchased by businesses. For example, about one-third of all baseball tickets and one-half of all hockey tickets are purchased by business firms.

REV-24 ELIMINATE STATE AND LOCAL TAX DEDUCTIBILITY

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Eliminate Deductibility of State and Local Taxes						
Income taxes	3.4	23.3	25.2	27.3	29.5	108.7
Sales taxes	0.8	5.2	5.7	6.3	6.9	25.0
Property taxes	1.8	12.0	13.2	14.5	15.9	57.3
Maintain Deductibility of Taxes Above Floor of 1 Percent of AGI	0.8	5.2	5.6	6.0	6.4	24.0

Current law allows taxpayers to deduct state and local taxes, including sales, income, real estate, and personal property taxes. These deductions are estimated to reduce revenues by about $190 billion between 1987 and 1991.

These deductions indirectly increase state and local revenues because they enable states to impose somewhat higher taxes than if taxpayers faced their full burden. In addition, the deductions tend to reduce differences in effective tax rates among states, which may to some extent diminish the importance of taxes in location decisions by business and households.

For people in high tax brackets, the deduction lowers the cost of supporting public services and induces higher spending levels in upper-income communities, particularly for such services as public education. These higher spending levels are subsidized by all taxpayers and may thwart state efforts to equalize spending levels among different communities. In some economically more diverse areas, such as central cities, the deduction may induce wealthy itemizers to favor higher spending for services that also benefit lower-income nonitemizers, but the impact on spending would not be as large as in high-income communities because fewer voters itemize. Without deductibility, however, higher-income itemizers might be less willing to reside in high-tax jurisdictions with large low-income populations.

While the deductions subsidize state and local expenditures, they reduce tax liability directly only for taxpayers who itemize--largely middle- and upper-income taxpayers. The value of the deductions increases with the marginal tax rate so that they are worth more to wealthy itemizers than to those in lower brackets. (This is also true for other deductions, such as mortgage interest and charitable contributions.) Finally, deductibility discourages states and localities from using nondeductible user fees, thereby inhibiting efficient pricing of some services.

On the other hand, to the extent that state and local taxes paid by any taxpayer exceed the benefits that taxpayer receives from state and local spending, deductibility can be regarded as a legitimate adjustment in measuring net income, and therefore the ability to pay federal taxes. Deductibility may also encourage states to impose more progressive taxes than they otherwise would. Advocates of deductibility also argue that it encourages states and localities to provide a greater quantity of public goods, such as education, transportation, and pollution control, which have spillover effects that benefit people outside the taxing jurisdiction. The belief that state and local public spending should be encouraged does not imply, however, that the current state and local deduction is necessarily the best way to do so, since it does direct a large share of the subsidy to upper-income communities.

The President's tax reform proposal would eliminate deductibility of all state and local taxes unless they are incurred in carrying on a trade or business. H.R. 3838 would retain deductibility. Other recent proposals call for partial elimination of state and local tax deductibility.

Some favor repeal only of the sales tax deduction. This would add about $25 billion to federal revenues between 1987 and 1991. The tax code generally allows deductions for relatively large and unpredictable expenses that affect a taxpayer's economic circumstances. Uniform expenses affecting nearly all taxpayers have traditionally been subsumed in the zero bracket amount and in the exemptions of the tax structure. The sales tax deduction, by virtue of the way it is computed (from standardized tax tables with amounts varying only by state, family size, and income) and its scope of coverage (claimed by nearly all itemizers) fails to meet these general criteria.

Advocates of the sales tax deductions argue that the federal government should not influence the states' choice of taxes by permitting only some of them to be deducted. Eliminating this deduction would be more burdensome for states relying heavily on sales taxes, and could cause some states to shift their tax collections from sales taxes to other taxes to preserve deductibility for their residents. To the extent other tax sources were substituted for the sales tax, the revenue gain would be reduced.

An alternative that would not discriminate among tax sources would be to permit deductions of all taxes above a fixed percentage of adjusted gross income (AGI). If the floor was set at 1 percent, revenues over the 1987-1991 period would increase by $24 billion. Such a measure would preserve most of the impact of the present deductions on public spending, but still capture taxes paid by upper-income itemizers. Another alternative would be to permit only a fraction of state and local taxes to be deductible. Yet another option would be to prohibit deductions above a fixed ceiling, which might be a percentage of adjusted gross income or a fixed dollar amount. A ceiling would result in greater variation in after-tax income from state to state and would largely eliminate the federal subsidy of public spending.

REV-25 LIMIT INTEREST DEDUCTIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Limit to Mortgage Interest on a Principal Residence Plus $5,000 in Excess of Net Investment Income	0.3	2.1	2.3	2.4	2.6	9.7
Limit to $20,000 (Joint Returns)or $15,000 (Other) in Excess of Net Investment Income	0.3	2.3	2.4	2.6	2.9	10.5

Current law allows taxpayers who itemize deductions to deduct all interest payments on home mortgages, auto loans, credit card balances, and other consumption borrowing. In addition, they can deduct interest on borrowing that is invested--for example, in stocks--but this deduction is limited to $10,000 in excess of net investment income. About one-third of all taxpayers itemize interest, claiming an average of almost $4,200 in 1983. As a result, the tax expenditure for this category is over $250 billion (for the period 1987 through 1991)--among the largest of conventionally defined tax expenditures.

Under an income tax, only interest that is a cost of earning taxable income is properly deductible. This does not include borrowing for homes, cars, and other assets that do not generate taxable income. (Deductibility of mortgage interest has been justified instead as an incentive to homeownership.)

Limiting interest deductions is one way to reduce tax shelter activity. High-bracket taxpayers may find it profitable to borrow in order to finance purchases of houses, consumer durables, and investment assets that generate tax-preferred income (such as partnership shares in extractive industries or real estate). When current interest deductions for an asset exceed currently taxable income from that asset, the excess interest deductions serve to shelter other income from tax. This "tax arbitrage" is the principle on which tax shelters operate.

The President's tax reform proposal would allow an unlimited deduction for interest payments on debt secured by the taxpayer's principal residence (limited to the fair market value of the home), but would limit deductions for other interest payments to $5,000 in excess of net investment income. The President's plan proposed a 10-year phase-in. Limiting only nonmortgage interest deductions would favor homes over cars, education, and other major purchases. Furthermore, homeowners might avoid the limit by using their homes as collateral to finance other purchases. Taking account of this behavior, this proposal is estimated to raise about $10 billion from 1987 through 1991, if implemented fully on January 1, 1987.

H.R. 3838 would limit itemized interest deductions to mortgage interest on a taxpayer's primary and secondary residences plus $20,000 (for joint returns, $10,000 for others) in excess of net investment income. If also implemented January 1, 1987, this provision would add less than $0.5 billion to revenues for the 1987-1991 period.

An alternative proposal to limit itemized interest deductions to $20,000 over investment income for joint returns and $15,000 for others would also leave a substantial incentive for home or other consumer borrowing. It would raise about $10.5 billion over the 1987-1991 period. At a 13 percent interest rate, taxpayers filing joint returns could deduct all interest on at least $150,000 of borrowing; single filers could deduct all interest on at least $115,000 of borrowing. Taxpayers with homes currently priced over $200,000, however, would probably suffer declines in the value of their homes.

Decreasing the incentive for further consumer borrowing would free savings for business investment, thereby offsetting in part a tax bias that favors investment in consumer durables. Those who favor retaining the deduction for nonbusiness interest note that otherwise many taxpayers could increase business-related borrowing to obtain cash for nonbusiness purchases. Consequently, eliminating deductions for nonbusiness borrowing would only affect taxpayers without sufficient financial wealth against which to collaterize loans for nonbusiness purposes. In short, it would raise the costs of financing housing, automobiles, and other consumer durables only for taxpayers without other sources of wealth.

REV-26 COMBINE MISCELLANEOUS DEDUCTIONS AND EMPLOYEE BUSINESS EXPENSE DEDUCTIONS AND SUBJECT TO A FLOOR OF 1 PERCENT OF AGI

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Treat Combined Deduction as an Adjustment to Income	0.3	2.1	2.3	2.5	2.7	9.9
Treat Combined Deduction as an Itemized Deduction	0.5	3.7	4.0	4.3	4.6	17.1

Current law generally allows taxpayers to deduct costs of producing income. In addition, certain employee business expenses are deductible when computing adjusted gross income (AGI) whether or not taxpayers itemize deductions, including expenses for travel, meals, and lodging while away from home, transportation expenses (except expenses of commuting to and from home), and business expenses of employees who are in sales. In 1983, about 8 percent of returns claimed a deduction for employee business expenses, with an average deduction of about $2,400 per return.

Other employee expenses are deductible only by taxpayers who itemize deductions. These are categorized as miscellaneous itemized deductions, and include employee business expenses for education, union and professional dues, safety equipment, small tools, supplies, uniforms, protective clothing, subscriptions to professional publications, and employment agency fees. Also allowed are gambling losses (limited to gambling winnings) and other expenses of producing income such as fees for investment services, rental fees for safe deposit boxes, trustee fees, and tax return preparation fees. About a third of all tax returns claim miscellaneous itemized deductions, with an average of about $630 per return.

Both the President's proposal and H.R. 3838 would combine miscellaneous itemized deductions with employee business expense deductions and limit the combined deduction to amounts in excess of 1 percent of AGI (computed without regard to the deduction). Under the President's proposal, the combined deduction would be allowed when computing adjusted gross income for both itemizers and nonitemizers. Under H.R. 3838, the combined deduction would be treated as an itemized deduction--that is, it would be available only to itemizers. The President's proposal would remove an inequity in the current law treatment of costs of producing income by making the deduction available on the same terms to nonitemizers and itemizers. The percent-of-AGI floor on the deduction in both proposals would simplify recordkeeping problems for taxpayers who now deduct only small amounts, and would reduce enforcement problems for the Internal Revenue Service. Both proposals, however, deny otherwise legitimate deductions to some taxpayers simply because the deductions are a small share of AGI. Of those who now claim miscellaneous itemized deductions, about half claim amounts smaller than 1 percent of AGI.

The 1 percent floor under miscellaneous deductions and employee business expenses, as proposed by the President, but implemented January 1, 1987, would increase federal revenues by about $10 billion between 1987 and 1991. If the deduction was available only to itemizers, as in H.R. 3838, but implemented January 1, 1987, the proposal would raise about $17 billion between 1987 and 1991.

REV-27 INCREASE TAXATION OF NON-MEANS-TESTED ENTITLEMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1989	1991	
Increase Taxation of Social Security and Railroad Retirement Tier I						
Tax 50 percent of benefits	2.2	7.5	7.9	8.3	8.8	34.7
Tax 85 percent of benefits	5.3	17.9	19.1	20.3	21.5	84.1
Tax All Unemployment Compensation	0.3	0.8	0.8	0.8	0.8	3.5
Tax Workers' Compensation and Black Lung Benefits	0.8	2.8	3.1	3.4	3.8	14.0

Under current tax law, certain entitlement benefits are included in adjusted gross income (AGI), while others are completely or partially excluded. Until recently, most entitlements were exempted from income taxation. But, because the transfer payments made to beneficiaries were small, the revenue loss from the tax exemptions was negligible. In recent years, however, such transfers have reached more well-to-do households and gradually accounted for large amounts of family income. If transfers were to be taxed the same way as other sources of personal income, it would be necessary to include in adjusted gross income all Social Security benefits and Railroad Retirement Tier I benefits in excess of employee contributions, all unemployment insurance benefits, and the income maintenance portion of workers' compensation benefits.

Other entitlement benefits currently not subject to tax include: the value of Medicare Hospital Insurance (HI) coverage in excess of an individual's HI payroll contribution; the subsidy for Supplemental Medical Insurance premiums (SMI) under Medicare; and all means-tested entitlement benefits. A proposal to include the value of HI coverage in excess of an individual's contributions and to tax the insurance value of SMI benefits in AGI is discussed elsewhere (see ENT-09). Revenue gains from including benefits from means-tested programs, such as Aid to Families with Dependent Children, in AGI would be small because few people who qualify for means-tested programs would have enough income to incur any federal income tax liability.

Increase the Taxation of Social Security and Tier I Railroad Retirement Benefits. Under current law, AGI includes the lesser of one-half of Social Security and Tier I Railroad Retirement benefits or one-half the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The threshold amount is $25,000 for single returns and $32,000 for joint returns.

Social Security benefits can be viewed as being analogous to private pensions because they are based on past earnings. Taxation of 50 percent of benefits would make the tax treatment roughly comparable over a worker's lifetime to the tax treatment of noncontributory pensions. Taxation of 85 percent of benefits would be roughly comparable to the tax treatment of contributory pensions for those with the lowest rate of return in Social Security and more favorable than the tax treatment of contributory pensions for other beneficiaries.

Eliminating the threshold (whether 50 percent or 85 percent of benefits are included in adjusted gross income) would have several advantages. First, it would make the taxation of these benefits more consistent with the taxation of other pension benefits, thereby strengthening the pension or deferred compensation logic of the program. Second, taxing benefits for all would reduce work or saving disincentives now facing beneficiaries near the threshold. Third, the complicated calculations under current law involving thresholds would be eliminated, thus simplifying tax compliance and administration.

On the other hand, reducing the current after-tax level of Social Security benefits would lower the standard of living of many of today's elderly people. This would be regarded by many as a violation of a social contract. Moreover, because Social Security constitutes a larger fraction of the retirement income of middle-income elderly and disabled people than of upper-income retirees, taxing their benefits at even a relatively low marginal tax rate would have a greater effect on their after-tax disposable income than it would on those higher in the income distribution. (Because of personal exemptions, including the extra exemption for those 65 and over, very-low-income people would remain tax-exempt even if all Social Security benefits were included in AGI.) If benefit levels were increased to offset this tax policy change, however, the budget deficit would not be reduced.

Alternatively, thresholds of $12,000 for single returns and $18,000 for joint returns could be set so that the taxation of benefits did not affect current beneficiaries in the lower portion of the income distribution. These thresholds would decrease the five-year revenue gain from about $35 billion to $14 billion if 50 percent of benefits were included in AGI, and from about $84 billion to $37 billion if 85 percent of benefits were included in AGI. As has happened with the thresholds under current law, inflation would slowly erode the value of these new thresholds and gradually move the result toward full taxation of 50 percent or 85 percent of benefits.[1]

Tax All Unemployment Insurance Benefits. Under current law, taxpayers must include unemployment insurance compensation in AGI using a graduated formula if their income exceeds thresholds of $18,000 for joint filers and $12,000 for single filers. Taxing all unemployment benefits would add $3.5 billion to revenues in 1987 through 1991. This provision was included in the President's tax reform proposal and in H.R. 3838.

The argument for including all unemployment insurance benefits in income is that doing so would tax these benefits the same way as the wages they replace, thereby making net unemployment insurance benefits received by any individual worker dependent on the total income of the family unit and reducing the work disincentives that these benefits may create. Opponents argue that inclusion of all benefits in AGI would impose a heavier burden on people who have suffered a large decline in income.

Tax Workers' Compensation and Black Lung Benefits. Workers' compensation benefits reimburse employees for medical costs and lost income resulting from work-related injuries. Black Lung benefits reimburse disabled coal miners who have pneumoneucleosis for medical costs and lost income. None of these benefits are taxable under current law. Including the income maintenance portion of these benefits in AGI would make their tax treatment consistent with that of other forms of income and would

---

1. See CBO, *An Analysis of Selected Deficit Reduction Options Affecting the Elderly and Disabled* (March 1985) and *An Analysis for Taxing Social Security as a Private Pension*(June 1985), for more detailed discussions of options for increasing taxation of Social Security benefits.

reduce work disincentives for disabled workers. Seventy-five percent of workers' compensation benefits cover income loss, and the remaining 25 percent cover medical costs. In some cases, the after-tax value of wages for those able to return to work is less than their tax-free benefits. Taxing the income maintenance portion of workers' compensation benefits and Black Lung benefits would add $14 billion to revenues in 1987 through 1991.

Opponents argue that damages for non-work-related injuries are not subject to tax, even though a portion of the damages reimburses for income loss, and that taxation of workers' compensation benefits would treat these two types of compensation inconsistently. They also argue that taxation of benefits would not significantly increase the incentive to work.

REV-28 ELIMINATE EXTRA TAX EXEMPTION FOR THE ELDERLY AND THE BLIND

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	1.7	3.5	3.8	4.3	4.6	17.9

Any taxpayer at least 65 years old or blind is permitted to claim an extra personal exemption. For tax year 1985, the personal exemption is $1,040; as a result of indexing, the personal exemption will be $1,080 for 1986. The most widely perceived reasons for these provisions are the lower income and extra costs of living (especially medical costs) of the elderly and the blind. Repeal of the extra exemption would increase revenues by $1.7 billion in 1987 and by about $18 billion between 1987 and 1991. Most of the revenue gain (98 percent) would be paid by the elderly.

The extra exemption is criticized on several grounds. First, neither age nor blindness is a particularly accurate indicator of financial need. In 1983, 43 percent of all extra exemptions for age and 40 percent of those for blindness were claimed by taxpayers with adjusted gross incomes above the median income. The poorest of the elderly and the blind--those whose incomes are so low that they do not file tax returns--do not benefit from the extra exemption at all. In 1983, 14.8 million exemptions were claimed out of an estimated 27.4 million elderly persons. Moreover, taxpayers with high incomes face higher marginal tax rates. Thus, the exemption gives them greater relief from tax than those with lower incomes.

Second, any elderly or blind taxpayer with extraordinary medical bills can deduct them from adjusted gross income. The extra exemption is neither needed to offset such expenses nor related to the size of a taxpayer's medical bills.

Third, the extra exemption was adopted in 1959 when Social Security benefits were low and the incidence of poverty among the elderly (35.2 percent) was much higher than among the population in general (22.4 percent). In 1984, largely because of Social Security, only 12.4 percent of the elderly were in poverty compared with 14.4 percent for all persons. Although some Social Security benefits are now partially taxed, benefits of taxpayers with modified adjusted gross incomes of less than $32,000 for joint returns ($25,000 for single returns) are not taxed.

Finally, the current tax law also provides a special credit for the elderly and the handicapped. A maximum credit of $750 ($1,125 for taxpayers filing joint returns) is available to elderly and disabled taxpayers who do not receive substantial amounts of tax-exempt pension income (including Social Security).

Proponents of retaining the exemption contend that it should be evaluated in the context of the overall benefits and tax advantages afforded the elderly. Social Security benefits are weighted in favor of those with low lifetime incomes and are taxable only for taxpayers with sufficient other income. The tax credit for the elderly is not available to taxpayers with incomes above certain thresholds. Eliminating the extra exemption would disrupt the redistributive balance in the existing package of entitlements and taxes.

If the Congress wished to protect needy taxpayers from the higher taxes resulting from repeal of the extra exemption, however, the present credit for the elderly and the disabled could be expanded. Raising the maximum credit by $150 ($300 for joint returns) would compensate most elderly taxpayers with up to average amounts of tax-exempt Social Security benefits for the elimination of the extra personal exemption. This increase in the credit would reduce the revenue pickup by only $0.6 billion in the years 1987 through 1991.

REV-29 DISALLOW INCOME AVERAGING FOR FORMER STUDENTS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.1	0.5	0.6	0.6	0.7	2.5

Under current law, income averaging is available to taxpayers whose incomes fluctuate greatly from one year to the next, or whose incomes rise dramatically in a given year. Such a taxpayer would have a higher tax liability over a period of several years than another taxpayer with the same total income, but a more even year-to-year pattern of earnings. This occurs because of the progressive rate structure and the arbitrary selection of one year as the appropriate accounting period for income measurement and taxation. Higher taxation of those with greater fluctuations of income is difficult to justify on grounds of fairness. As a result, income averaging was enacted in 1964 to reduce tax liabilities on fluctuating income in high-income years.

Income averaging allows a lower marginal tax rate to apply to a portion of the current year's income than would apply under the regular tax rate schedules. From 1969 to 1983, a taxpayer was eligible for income averaging if his or her current year's income exceeded by $3,000 or more 120 percent of his average taxable income in the previous four years (the "base period"). In 1969, 0.9 percent of all tax returns used the averaging formula to compute tax liability. By 1983, the portion had risen to 5.6 percent. Because the Congress believed that much of this increase occurred simply because inflation drove up nominal incomes, it tightened the averaging rules in the Deficit Reduction Act of 1984. Under present law, a taxpayer's current-year income must exceed by $3,000 or more 140 percent of his average income over the previous three years. This is expected to reduce the averaging population by about a third.

Income averaging has always been intended to provide relief to taxpayers who are self-supporting. Under current rules, however, some taxpayers who were not fully self-supporting during the base period can use the averaging method of tax computation. This problem could be reduced by disallowing income averaging for former students. Recent proposals would disallow it for any taxpayer who had been a full-time student during any of the three years of the base period. This restriction would not apply to married people whose current-year income contributed 25 percent or less to joint current-year income.

Proponents of this change argue that income averaging should be available only for those with unpredictable or uncontrollable fluctuations in income. In contrast, the sharp increase in incomes of former students entering the job market is predictable and intentional. Additionally, it is believed that this change would reduce complexity. The need to maintain records for several consecutive years and to prove one's self-supporting status has been burdensome for some taxpayers and has caused disputes between taxpayers and the Internal Revenue Service.

Tax reform proposals that lower and flatten marginal tax rates reduce the rationale for any income averaging. Both the President's tax reform proposal and H.R. 3838 would eliminate income averaging entirely. Under the current tax rate structure, however, strong equity arguments for some form of income averaging remain.

REV-30 IMPROVE TAX COMPLIANCE AND ENFORCEMENT

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Increase IRS Audit Coverage a/	0.3	0.6	0.8	0.9	1.0	3.6
Increase Penalties for Failure to Comply with Tax Laws	0.4	0.4	0.4	0.4	0.4	1.9

a. Net of increased outlays.

Compliance with the tax laws appears to have declined significantly during the 1970s. The Internal Revenue Service (IRS) estimates that about $91 billion in taxes owed went unpaid in 1981, a nearly threefold increase over 1973 (or a 58 percent increase after adjusting for inflation). Since 1981, however, marginal tax rates have been lowered by 23 percent, and a number of provisions have been enacted to improve the reporting of income. Thus, although noncompliance remains a severe problem and no current data or estimates are available, it is likely that the gap between taxes owed and taxes paid (the "tax gap") has declined since 1981.

Although illegal activities are responsible for part of the tax gap, the IRS estimates that 90 percent of the revenue shortfall is the result of false reporting of taxable income from legal activities. Income underreported by individuals was estimated to account for 58 percent of the tax gap--about $52 billion in 1981. Overstated expenses, deductions, and credits accounted for $13 billion; failure to file returns for $3 billion; and underpayments for about $7 billion. Corporations were responsible for only $6 billion or 6.9 percent of the tax gap.

Increase IRS Audit Coverage. One way to improve compliance is to increase the probability that a taxpayer will be audited. The number of examiners and the data processing capacity at the IRS have not kept pace with either the increased work load or the increasing complexity of the tax code. Audit coverage has fallen from 2.6 percent of all returns in 1976 to 1.3 percent in 1985. Adding new IRS staff could bring an immediate and large payoff in revenues--estimated to be about $16 for each additional dollar spent if the increased number of auditors are assigned only to high-income returns. A permanent increase in staff of 1,550 examiners beginning October 1, 1986, would raise about $0.3 billion in 1987 and $3.9 billion over the 1987-1991 period. These additional revenues would be partly offset by about $0.2 billion in 1987-1991 outlays for additional staffing and other resources. This increased audit coverage, however, would impose additional compliance burdens on all taxpayers--including honest ones.

The President's budget would add approximately 2,500 employees each year to the examination staff between 1987 and 1989, for a total increase of 7,500 employees. This is estimated to increase revenues by $10.4 billion between 1987 and 1991, with an offsetting increase in staffing costs of $1.3 billion.

Increase Penalties for Failure to Comply with Tax Laws. An alternative way of improving compliance is to increase penalties for failure to pay taxes and for supplying incorrect information to the IRS. Possible changes include increasing the penalty for taxpayers failing to pay taxes when due from 0.5 percent to 1.0 percent of the underpayment per month for every month after the IRS must switch to more expensive collection methods; increasing the maximum penalty for failure by income sources to file information returns or to supply a copy to the taxpayer from $50,000 to $100,000; and increasing the penalty on underpayments in cases of taxpayer fraud from 50 percent to 75 percent, while narrowing the base on which the penalty is imposed to include only the portion of the underpayment directly attributable to fraud.

H.R. 3838 includes these and other changes in the penalty structure. It is estimated that the increased penalties in H.R. 3838 would increase revenues by $0.4 billion in 1987 and by about $2 billion in 1987 through 1991.

The proposed increases can be justified as making penalties more closely correspond to the average cost of collecting delinquent taxes, although the costs and penalties would not be closely matched for any given taxpayer. In addition, in the case of fraud, narrowing the base would make the penalty correspond more closely to the fraudulent behavior. While these modifications in the penalty structure would increase revenues, it is not clear that they would significantly improve voluntary tax compliance. Increased collections from those who failed to comply, however, might be regarded as desirable even if total compliance was not significantly affected.

The President's budget would replace existing penalties with charges based on the cost of collecting overdue tax payments, for an increase in revenues of $0.3 billion in 1987 and about $1.8 billion in 1987 through 1991.

REV-31 REDUCE TAX PREFERENCES ACROSS THE BOARD

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	9	37	44	50	57	197

Significant revenue could be raised by reducing tax preferences. Tax preferences are the deductions, exclusions, and credits that reduce the tax payments of selected persons and businesses; they do not include deductions for valid costs of doing business. Elimination of tax preferences on an item-by-item basis might be very difficult because groups who would lose tax benefits strongly oppose such changes. An across-the-board partial reduction in preferences might be politically more feasible since it would not single out specific groups of taxpayers for large tax increases. Preference reductions would complement the across-the-board reductions in direct federal expenditures that may occur under provisions of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177). Proposals to reduce preferences are generally offered as alternatives to tax rate increases as a way of raising federal revenues.

One proposal to reduce tax preferences calls for a 10 percent cut in itemized (personal) deductions and a 20 percent reduction in most credits, exclusions, and other deductions that are regarded as tax preferences for both individuals and corporations. The proposal would also lengthen depreciation lives by 20 percent, tighten limits that apply to some tax preferences by the same percentage, and increase the tax rate of the alternative minimum tax on individuals from 20 percent to 26 percent. It would raise an estimated $197 billion in revenues during the 1987-1991 period. To the extent that tax reform would reduce or eliminate tax preferences, less revenue could be raised by scaling back remaining preferences.

A variant of this proposal would use 15 percent when scaling back all preferences, and would increase the alternative minimum tax rate to 24.5 percent. This version of the proposal would raise less revenue overall, about $186 billion from 1987 through 1991, with a larger share of revenues raised from individuals who itemize deductions and a smaller share from other individuals and corporate and noncorporate businesses.

An across-the-board reduction in preferences would in general raise more revenue from those taxpayers currently receiving relatively larger total tax benefits, in contrast to an income tax surtax that would raise the most revenues from those already paying the most in taxes. As a result, it would reduce differences in taxes paid by taxpayers with similar incomes who make different use of tax preferences, and would make after-tax returns to different economic activities more equal. Consequently, a uniform reduction in preferences would probably increase fairness and involve a smaller loss in efficiency than would higher statutory tax rates that raised equal revenues.

Cutting preferences across the board might reduce preferences that arguably promote legitimate public objectives, such as encouraging charitable giving. Equal percentage cuts in preferences might have unequal effects on economic incentives since, for example, a 10 percent reduction in a credit will have a larger after-tax effect on incentives than a 10 percent cut in a deduction. Finally, it is sometimes arguable whether a deduction, credit, or exclusion is a subsidy to some taxpayers or activities, or is a correction for problems of properly measuring income and therefore not actually a tax preference.

REV-32 EXPAND MINIMUM TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Expand Existing Individual Alternative Minimum Tax						
Option I						
At 20 percent	0.1	0.3	0.3	0.3	0.4	1.1
At 25 percent	1.4	7.1	8.7	10.7	13.2	41.1
Option II						
At 25 percent	0.9	5.0	6.0	5.5	4.9	22.3
Expand Base of Present Corporate Add-on Minimum Tax						
At 15 percent	1.0	3.3	5.4	8.5	13.4	31.7
At 20 percent	1.4	4.6	7.3	11.6	18.1	43.0
Replace Add-on Corporate Tax with a Broad-Based Alternative Minimum Tax						
At 15 percent	0.7	1.4	2.0	2.9	4.3	11.3
At 20 percent	1.1	2.2	3.2	4.6	6.7	17.8
At 25 percent	2.1	4.1	5.4	7.2	9.6	28.4

Under current law, individual taxpayers who make extensive use of certain preferences may be subject to a 20 percent alternative minimum tax (AMT) on an alternative tax base that includes those preferences. Alternative minimum taxable income (AMTI) is calculated by adding specified preferences to adjusted gross income (AGI), subtracting specified itemized deductions, and then subtracting an AMT exemption of $40,000 for a joint return, $30,000 for a single or head-of-household return, or $20,000 for married couples filing separately. Also, under current law, a corporation that makes extensive use of tax preferences may be subject to an add-on minimum tax equal to 15 percent of the difference between the total of certain tax preferences and the greater of either $10,000 or its regular income tax liability.

These minimum taxes could be expanded by including more items in the lists of preferences subject to the taxes. The revenue gain would depend on the rate and on the number and size of preferences included. Another option is to replace the present additional tax on corporate tax preferences with an alternative minimum tax on an expanded income base. Again, the revenue effect would depend on how much the base was expanded, with the greatest revenue gain expected from a minimum tax on economic income.

Expand Existing Individual AMT. This discussion of the individual AMT includes two options. The first option would slightly reduce the AMT exemption compared with present law and expand the list of minimum tax preferences, for instance by including all accelerated depreciation on new investment in AMTI instead of only the portion included under current law. (For the minimum taxes shown here, the accelerated depreciation preference is defined as the difference between ACRS depreciation and straight-line depreciation over ADR midpoint lives for machinery and equipment and 40 years for structures.) The one completely new preference added to AMTI under the first option would be any appreciation in the value of property donated to charity that had not been included in AGI.

The second option would include all the changes in the first option plus three new preferences: interest on newly issued tax-exempt non-governmental obligations (excluding refundings of pre-1987 bonds); deductions under the completed contract method of accounting in excess of the percentage of completion method; and net business losses that are deductible under the regular tax, but are associated with activities in which the taxpayer was a passive investor. It would substitute for the present provision, which allows incentive credits that do not benefit the taxpayer because of the minimum tax to be carried over against the regular tax, a more liberal provision that any minimum tax paid be carried over as a credit against future regular taxes. Because taxpayers switch back and forth between the AMT and the regular tax, this change in credit provisions would leave many with lower total tax liabilities than under present law. For this reason, Option II has a significantly smaller revenue gain than the 25 percent AMT in Option I, even though it has a broader base.

The individual minimum tax included in the President's tax reform proposal is similar to the 20 percent Option I minimum tax discussed here, and the proposal in H.R. 3838 is similar to the Option II minimum tax. In both tax reform proposals, the revenue effect of an alternative minimum tax is different than reported above, because it is combined with other major tax changes.

Expand Base of Present Corporate Add-on Tax. At the current 15 percent rate, a very broad expansion of the present add-on corporate minimum tax could add as much as $32 billion to revenues over the 1987-1991 period. At a higher rate on the same expanded base, the additional revenue raised by an add-on minimum tax would be roughly proportional to the increase in the rate.

Replace Add-on Corporate Tax with an AMT. Another option would be to replace the add-on corporate minimum tax with a broad-based corporate AMT. At 15 percent, a corporate AMT with approximately the same base as the expanded add-on tax discussed above, and with an exclusion of $40,000, would increase revenues by about $11 billion between 1987 and 1991. A broad-based corporate AMT with a 25 percent rate, which would be similar to the corporate AMT in H.R. 3838, would raise about $28 billion over the same period.

Incentive tax credits are not allowed against either of the corporate minimum taxes discussed above. In order to avoid double taxation of corporations that pay the AMT only in some years, however, under the corporate AMT proposal any AMT paid would be carried over to future years as a credit against regular tax liability. This provision limits the growth of net revenue from the AMT, because corporations that trigger off the AMT by becoming liable for the regular tax can quickly recover what they had paid under the AMT. This contributes to the smaller revenue gain from an AMT compared to the add-on minimum tax, and also to the slower growth in revenue from an AMT.

A minimum tax reduces the ability of individuals and corporations with economic income to escape income tax completely, or to shelter major portions of their income from taxation. At the same time, it reduces the value of incentives that were enacted to promote activities that the Congress felt should be encouraged. Also, a minimum tax increases the complexity of the tax system: under some circumstances, an AMT could hit some taxpayers harder than intended, or cause them to engage in more tax-motivated behavior than the incentives it reduced. An AMT would be especially disruptive to corporate planning because its impact on the value of any particular incentive would depend on the timing and mix of all the incentives used by the corporation, and because the tax could be triggered on and off frequently. On the other hand, only taxpayers with incomes above the exclusion and regular effective tax rates below the AMT rate would be affected by the AMT.

As with all the revenue estimates in this report, the significant revenue increases shown for these broad-based minimum taxes are estimated on the assumption that no other changes would be made in current law. Any general tax reform that restricted preferences would reduce the additional revenue to be gained from a minimum tax. As long as preferences were not completely eliminated, however, a minimum tax might still be a significant revenue source.

If an increase in the total level of taxes paid by corporations and high-income individuals became a general goal of public policy, a broad-based minimum tax would be more neutral than a surtax on tax liability or an increase in the general rate. It would be more complex, however, and less neutral, than direct measures to broaden the regular tax base, including some--such as a broad scaling back of preferences (see REV-31)--that would have many of the positive attributes of a minimum tax. An add-on minimum would probably cause less economic distortion, and might raise revenue more efficiently than an AMT, but would not as directly promote the objective of affecting only corporations and individuals that received significant economic income and paid little or no tax.

REV-33 REPEAL THE POSSESSIONS TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	1.1	1.9	2.1	2.3	2.6	10.0

Income earned by U.S. corporations operating in Puerto Rico or U.S. possessions is generally treated as foreign-source income, and the federal tax on such income is offset by the foreign tax credit (FTC) for any tax paid to the possession. Use of the FTC would prevent such income from being subject to income tax in both the United States and the possession. In order to promote employment, however, current law provides a more generous treatment for certain business and qualified investment income from Puerto Rico and U.S. possessions; this can have the effect of exempting such income from being taxed by either government. A corporation that received at least 80 percent of its gross income for the last three years from sources within Puerto Rico or any U.S. possession other than the Virgin Islands (at least 65 percent from the active conduct of a trade or business) may claim a possessions tax credit instead of the FTC. (Income from the Virgin Islands is treated similarly, but under a different tax provision.) The possessions tax credit is equal to the U.S. tax on the qualified possessions source income, and can be claimed even if no tax was paid to the possession.

The principal argument for repeal is that use of this incentive has provided significant tax benefits to certain businesses, especially pharmaceutical manufacturers, without correspondingly significant increases in employment in U.S. possessions. Despite very complex limitations enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the primary incentive provided by the credit is to allocate to possessions the income from intangible assets developed in the United States. Opponents argue that the incentive is needed to promote investment and employment.

The President's tax reform proposal suggests replacing the possessions tax credit with a wage credit on the grounds that the latter would be a more efficient employment incentive. H.R. 3838 would tighten the rules and restrictions governing the use of the possessions tax credit, but would have little effect on the revenue loss from the credit.

REV-34 PLACE A PER-COUNTRY LIMIT ON THE FOREIGN TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.8	2.0	2.3	2.6	2.9	10.6

Under present law, U.S. taxpayers are allowed a credit for foreign income taxes paid. The credit is limited to the amount of U.S. tax that would otherwise be owed on the foreign-source income. This limit is intended to prevent use of the foreign tax credit to offset foreign tax rates higher than the U.S. rate. The limitation applies to the overall total of foreign taxes, rather than applying separately to taxes paid on income from each country. As a result, a taxpayer with investments in a country with a tax rate higher than the U.S. rate can reduce tax payments by also investing in a foreign country with a low tax rate. The foreign tax credit from the high-tax country can then be used to reduce U.S. taxes on income from the low-tax country.

If the foreign tax credit was computed on a per-country basis, taxpayers with excess foreign tax credits from investments in high-tax countries would no longer be able to reduce their total tax burdens by shifting investment from the United States to low-tax countries. This proposal would prevent the foreign tax credit from distorting investment decisions, but it would be difficult to enforce because foreign taxes and income sources would have to be matched explicitly. Foreign subsidiaries operating in more than one country would have strong incentives to shift reported income between high- and low-tax countries in order to circumvent the per country limitation.

A per-country limitation on the foreign tax credit would add about $11 billion to federal revenues between 1987 and 1991. The President's tax reform proposal includes a per-country limitation. H.R. 3838 would impose separate limits on credits associated with four categories of income: high-tax, low-tax, financial, and shipping.

REV-35 TAX CAPITAL GAINS AT DEATH

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	a/	4.6	4.9	5.3	5.6	20.4

a. Less than $50 million.

Realized capital gains are taxed as income. An exception occurs when a person sells an inherited asset. Only the gain since the date of inheritance is taxable. (The full value of the inheritance may have been taxed, however, under the separate estate and gift transfer tax if the inheritance was large enough.) The income tax exception could be removed either by taxing capital gains on the decedent's final income tax return, or by requiring the beneficiary to carry forward the decedent's cost basis (generally the original purchase price, less any adjustments). Taxation of gains at death would raise about $20 billion from 1987 through 1991.

Taxation of capital gains at death would reduce opportunities for wealthy families to avoid tax permanently on an important source of their income.. In addition, it would reduce the bias in current law that favors investments in assets that appreciate in value over investments in assets that pay regular cash returns. An advantage for appreciating assets would continue, however, both because of the continued exclusion from tax of 60 percent of long-term capital gains and because of the continued deferral of tax on accrued capital gains income until death. Another benefit of taxation of gains at death is that it would reduce the "lock-in" effect of the current capital gains tax; taxpayers could not avoid capital gains taxes permanently by holding onto appreciated assets rather than selling them. Finally, the recent lowering of estate taxes has made it more important to ensure that income accumulated within a person's lifetime not escape tax when assets are transferred at death.

The major arguments against taxing gains at death are that it would reduce the incentive to save by raising the expected value of future capital gains taxes, and that in some cases, such as small farms or businesses, it could force an estate to liquidate assets in order to pay the tax. The forced sale problem could be reduced by allowing generous averaging provisions and deferral of tax payments.

As an alternative to taxing gains at death, the heir could be made to carry forward the decedent's cost basis (carryover basis). This would avoid the liquidity problem mentioned above. Critics have argued that carryover basis would create serious recordkeeping problems because heirs would need to know the prices paid by the decedent for assets purchased many years before to compute their tax liability when they came to sell them. Compared to taxation at death, the carryover basis allows a continued tax deferral on the unrealized gain.

In the Tax Reform Act of 1976, the Congress enacted carryover basis for assets transferred at death, but this provision never took effect and was repealed in 1980. Neither carryover basis nor the taxation of gains at death is included in a major tax reform proposal.

As noted, in addition to imposing income tax liability on realized capital gains, the federal government imposes an estate and gift transfer tax on capital assets when the inheritance is large enough. The Economic Recovery Tax Act of 1981 enacted gradual increases in the exemption below which estates do not pay taxes. In 1985, the exemption was $400,000; it will increase to $500,000 in 1986 and $600,000 in 1987. ERTA also legislated decreases in the maximum estate and gift tax rate. The last of these decreases will take place in 1988 (under a subsequent change enacted in 1984).

Some observers have suggested that if the income tax continues to excuse liability on unrealized capital gains at death, the estate and gift tax should be tightened to impose a greater transfer levy on those gains. One means to accomplish that end would be to freeze the estate tax exemption at the 1985 level of $400,000 and to freeze the current rate schedule. These changes would increase revenues by about $9 billion over the 1987-1991 period.

APPENDIX

SUMMARY TABLE OF SPENDING AND TAXATION OPTIONS BY BUDGET FUNCTION

The table that follows lists deficit reduction options by budget function. When an option affects several functions, it is assigned to the function on which it has the largest impact. Some spending options affect all functions, and some taxation options cannot be classified by function at all. Options of this kind are carried at the end of the table.

The title for each option is followed by a designation of its category in parentheses--for example, Slow Growth in the Strategic Defense Initiative (DEF-16) or Limit Interest Deductions (REV-25). The designation permits locating the option in the table of contents at the beginning of this volume.

For each option, the table displays the estimated 1987-1991 savings or revenue gains that would result from enactment. Both budget authority and outlay savings are generally shown for the spending reduction options. Revenue increases are listed as additions to CBO baseline. The estimates do not include any secondary effects--that is, effects on spending or revenues that would occur if the performance of the economy as a whole were altered by enacting the options shown here.

Unless specified otherwise, the estimates assume that the spending reduction options in the table will take effect on October 1, 1986, and the taxation options on January 1, 1987. The separate options cannot be added to a grand total. Some are mutually exclusive; some overlap with others; and in some cases there are interactions, so that if several options were enacted together, the combined savings would differ from the total of those estimated for each option separately.

SUMMARY TABLE PROJECTED SAVINGS AND REVENUE GAINS, BY BUDGET FUNCTION, FISCAL YEARS 1987-1991 (In millions of dollars)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense						
Amend the Administration's Airlift Plan (DEF-01)						
Budget Authority	830	2,290	2,010	2,470	4,220	11,820
Outlays	340	850	1,360	1,550	1,900	6,000
Reduce Construction of New Submarines and Extend the Service Life of Existing Ships (DEF-02)						
Budget Authority	1,040	160	1,510	1,020	940	4,670
Outlays	-60	140	280	450	650	1,580
Cancel or Reduce Procurement of the F-15 (DEF-03)						
Freeze Annual Procurement at 36						
Budget Authority	400	400	400	400	400	2,000
Outlays	30	170	280	320	350	1,150
Cancel the F-15						
Budget Authority	2,240	2,240	2,260	2,100	2,100	10,940
Outlays	250	1,000	1,540	1,790	1,900	6,480
Cancel the Army Helicopter Improvement Program (DEF-04)						
Budget Authority	250	240	350	380	350	1,570
Outlays	40	140	220	290	330	1,020

NOTE: Dashes in this table indicate less than $2.5 million.

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Cancel Procurement of Aquila Remotely Piloted Vehicle (DEF-05)						
Budget Authority	140	190	170	40	20	560
Outlays	10	60	130	150	110	460
Cancel V-22 Aircraft Development (DEF-06)						
Budget Authority	390	590	790	1,190	1,890	4,850
Outlays	200	400	300	450	850	2,200
Cancel E-6 Aircraft Procurement (DEF-07)						
Budget Authority	410	380	360	300	10	1,460
Outlays	70	200	270	300	280	1,120
Cancel M9ACE Armored Combat Earthmover (DEF-08)						
Budget Authority	30	160	100	100	120	510
Outlays	2	20	75	100	100	297
Cancel the Advanced Medium-Range, Air-to-Air Missile (DEF-09)						
Budget Authority	810	1,080	1,170	1,110	900	5,070
Outlays	210	510	760	900	900	3,280

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Delay Advanced Tactical Fighter (ATF) Development (DEF-10)						
Budget Authority	290	340	580	700	2,400	4,310
Outlays	150	280	440	590	1,420	2,880
Delay Procurement of Trident II Missile (DEF-11)						
Budget Authority	1,430	2,290	2,300	2,300	1,670	9,990
Outlays	150	750	1,480	1,940	2,070	6,390
Cancel the Bradley Fighting Vehicle (DEF-12)						
Budget Authority	800	630	340	280	0	2,050
Outlays	20	370	530	450	340	1,710
Reduce MX Test Missiles (DEF-13)						
Budget Authority	600	1,500	1,400	1,200	270	4,970
Outlays	140	540	920	1,100	890	3,590
Alter Funding for Supporting Procurement (DEF-14)						
Limit 1987 Spending to Zero Real Growth						
Budget Authority	3,600	3,400	3,700	3,900	4,200	18,800
Outlays	1,300	2,100	2,900	3,400	3,700	13,400

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Alter Funding for Supporting Procurement (DEF-14) (Continued)						
Limit 1987 Funding to Zero Nominal Growth						
Budget Authority	4,400	3,800	5,200	5,900	6,700	26,000
Outlays	1,500	1,900	3,200	4,200	5,200	16,000
Alter Research and Development Funding (DEF-15)						
Reduce 1987 Funding Request by 10 Percent						
Budget Authority	4,200	4,200	4,100	4,200	4,700	21,400
Outlays	2,100	3,600	3,900	4,000	4,300	17,900
Limit Funding to Real 1986 Level						
Budget Authority	7,500	6,300	4,100	3,100	6,200	27,200
Outlays	3,800	5,900	4,800	3,600	4,700	22,800
Slow Growth in the Strategic Defense Initiative (DEF-16)						
Budget Authority	1,100	1,300	1,500	1,800	2,100	7,800
Outlays	500	1,040	1,290	1,550	1,830	6,210
Alter Funding for Military Construction (DEF-17)						
Budget Authority	1,500	3,500	3,300	4,500	4,100	16,900
Outlays	200	1,100	2,200	3,000	3,700	10,200

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Slow Increases in the Tactical Air Force (DEF-18)						
Savings in Total Federal Budget						
Budget Authority	0	170	540	940	1,180	2,830
Outlays	0	90	320	620	860	1,890
Savings in Defense Budget						
Budget Authority	0	170	540	940	1,180	2,830
Outlays	0	110	380	720	980	2,190
Place Three Carrier Battle Groups in Reserve (DEF-19)						
Savings in Total Federal Budget						
Budget Authority	0	70	210	330	420	1,030
Outlays	0	50	140	230	300	720
Savings in Defense Budget						
Budget Authority	0	70	210	330	420	1,030
Outlays	0	60	190	310	400	960
Retire Some G-Model B-52 Strategic Bombers Early (DEF-20)						
Savings in Total Federal Budget						
Budget Authority	270	840	1,180	1,240	1,300	4,830
Outlays	130	470	780	940	1,050	3,370
Savings in Defense Budget						
Budget Authority	270	840	1,180	1,240	1,300	4,830
Outlays	150	540	880	1,050	1,160	3,780

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Alter Operation and Maintenance Funding (DEF-21)						
Reduce 1987 Funding Request by 10 Percent						
Budget Authority	8,600	9,200	10,000	10,700	11,200	49,700
Outlays	6,700	8,700	9,600	10,300	10,800	46,100
Limit Funding Growth in Each of the Next Five Years						
Budget Authority	11,500	14,000	17,500	21,200	21,600	85,800
Outlays	9,000	12,900	16,300	19,900	20,900	79,000
Restore Former Enlisted-Officer Ratios (DEF-22)						
Savings in Total Federal Budget						
Budget Authority	102	372	714	954	1,035	3,177
Outlays	70	259	504	682	747	2,262
Savings in Defense Budget						
Budget Authority	106	388	745	988	1,075	3,302
Outlays	103	380	734	981	1,072	3,270
Impose Fees for Military Outpatient Care (DEF-23)						
Budget Authority	95	100	110	120	130	555
Outlays	75	95	104	115	125	515

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Selectively Raise Military Pay (DEF-24)						
Savings in Total Federal Budget						
Budget Authority	2,300	2,375	2,455	2,545	2,630	12,305
Outlays	1,570	1,625	1,665	1,705	1,745	8,310
Savings in Defense Budget						
Budget Authority	2,360	2,435	2,520	2,615	2,705	12,635
Outlays	2,325	2,435	2,520	2,610	2,705	12,595
Implement Proposed Changes in Military Retirement (DEF-25)						
Savings in Total Federal Budget						
Budget Authority	134	411	704	993	1,243	3,485
Outlays	0	-1	-5	-16	-27	-49
Savings in Defense Budget						
Budget Authority	134	411	704	993	1,243	3,485
Outlays	134	411	704	993	1,243	3,485
Tax Cash Allowances and the Rental Value of Housing Provided to Persons in the Uniformed Services and the Clergy (REV-22)						
Addition to CBO Baseline						
Tax All Allowances	1,700	2,500	2,600	2,800	2,900	12,500

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
050 National Defense (Continued)						
Tax Cash Allowances and the Rental Value of Housing Provided to Persons in the Uniformed Services and the Clergy (REV-22) (Continued)						
Addition to CBO Baseline (Continued)						
Limit Homeowners' Interest Deductions	100	300	400	300	400	1,500
150 International Affairs						
Reduce Funding for Foreign Aid (NDD-05)						
Budget Authority	1,416	1,601	1,661	1,725	1,794	8,198
Outlays	716	974	1,231	1,429	1,555	5,905
Eliminate Cargo Preference for Nonmilitary Shipments (NDD-10)						
Budget Authority	500	550	600	600	600	2,850
Outlays	500	550	600	600	600	2,850
End the Export-Import Bank Direct Loan Program (NDD-18)						
Budget Authority	400	800	0	0	0	1,200
Outlays	200	400	500	500	500	1,900

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
150 International Affairs (Continued)						
Repeal the Possessions Tax Credit (REV-33)						
Addition to CBO Baseline	1,100	1,900	2,100	2,300	2,600	10,000
Place a Per Country Limit on the Foreign Tax Credit (REV-34)						
Addition to CBO Baseline	800	2,000	2,300	2,600	2,900	10,600
270 Energy						
Reduce Support for Energy Supply, Conservation, and the Strategic Petroleum Reserve (NDD-02)						
Budget Authority	2,650	3,000	3,500	3,800	4,000	17,000
Outlays	1,300	2,450	3,200	3,600	3,850	14,400
Reduce Credit Subsidies to Federal Power Marketing Agencies (NDD-17)						
Budget Authority	88	259	236	211	193	987
Outlays	144	569	504	433	368	2,018

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
270 Energy (Continued)						
Increase Energy Taxes (REV-05)						
Addition to CBO Baseline						
Impose Tax on Domestic and Imported Oil ($5 per barrel)	20,400	21,800	22,100	22,500	22,900	109,700
Impose Oil Import Fee ($5 per barrel)	7,400	7,300	7,400	7,800	7,900	37,800
Impose Excise Tax on Natural Gas ($1 per 1,000 cubic feet)	12,000	12,900	13,200	13,600	13,700	65,400
Increase Motor Fuel Excise Tax (12 cents per gallon)	10,400	10,700	10,900	10,900	10,900	53,800
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	13,900	15,200	16,200	17,300	18,500	81,100

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
270 Energy (Continued)						
Repeal Percentage Depletion Allowance and Expensing of Intangible Drilling, Exploration, and Development Costs (REV-11)						
Addition to CBO Baseline						
Repeal Percentage Depletion	900	1,400	1,400	1,500	1,500	6,700
Repeal Expensing of Intangible Drilling, Development, and Exploration Costs	2,000	3,100	2,700	2,400	2,000	12,100
300 Natural Resources and Environment						
Reduce Support for Inland Waterways (NDD-11)						
Budget Authority	260	270	280	290	300	1,400
Outlays	250	260	270	280	290	1,350
Eliminate Federal Maintenance Assistance for Deep Draft Ports (NDD-12)						
Budget Authority	440	460	470	490	500	2,360
Outlays	430	450	460	480	500	2,320

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
300 Natural Resources and Environment (Continued)						
Eliminate Federal Support to States for Construction of Sewage Treatment Plants (NDD-16)						
Budget Authority	705	1,442	2,180	2,930	3,089	10,346
Outlays	5	93	393	890	1,486	2,867
Eliminate Special Capital Gains Treatment for Timber, and for Coal and Iron Ore Royalties (REV-13)						
Addition to CBO Baseline						
Timber Income	300	700	700	800	800	3,300
Coal and Iron Ore Royalties	100	100	100	100	200	700
350 Agriculture						
Reduce Deficiency Payments by Lowering Target Prices (AGR-01)						
Budget Authority	500	2,040	2,940	2,790	2,350	10,620
Outlays	500	2,040	2,940	2,790	2,350	10,620
Eliminate Deficiency Payments on Excess Acreage (AGR-02)						
Budget Authority	470	2,450	2,980	1,420	1,025	8,345
Outlays	470	2,450	2,980	1,420	1,025	8,345

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
350 Agriculture (Continued)						
Reduce Deficiency Payments by Lowering Payment Limitation (AGR-03)						
Budget Authority	0	2,030	2,160	1,930	1,515	7,635
Outlays	0	2,030	2,160	1,930	1,515	7,635
370 Commerce and Housing						
Recover the Administrative Costs of Selected Regulatory Agencies (NDD-06)						
Savings from CBO Baseline						
USDA	132	270	415	424	433	1,674
FDA	58	119	184	189	193	743
FCC	18	40	61	62	64	245
CFTC	9	18	27	28	29	111
Charge State Member Banks and Bank Holding Companies for the Costs of Federal Reserve Supervision and Regulation (NDD-07)						
Addition to CBO Baseline	190	210	230	240	260	1,130
Discontinue Postal Subsidies for Not-for-Profit Organizations (NDD-19)						
Budget Authority	490	530	550	570	610	2,750
Outlays	490	530	550	570	610	2,750

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Eliminate New Lending or Increase Homeowners' Payments Under Rural Housing Loan Program (NDD-21)						
Eliminate New Lending						
Budget Authority	1,050	1,250	1,200	1,100	1,050	5,650
Outlays	1,000	1,200	1,200	1,200	1,200	5,800
Increase Homeowners' Payments						
Budget Authority	-15	-35	95	95	85	230
Outlays	35	75	120	160	210	600
Impose a One-Year Moratorium on New Funding for the Rural Rental Assistance Program (NDD-22)						
Budget Authority	55	30	-15	-20	-60	-10
Outlays	50	390	120	30	-20	570
Revise Depreciation Rules (REV-07)						
Addition to CBO Baseline						
Ways and Means Proposal	13,000	27,300	38,900	53,200	75,900	208,300
President's Proposal	12,400	24,200	32,400	43,900	53,100	166,000

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Match Income with Expense for Multiperiod Construction (REV-08)						
Addition to CBO Baseline	2,400	8,200	12,400	10,200	7,500	40,800
Eliminate Investment Tax Credit or Require Full Basis Adjustment (REV-09)						
Addition to CBO Baseline						
Eliminate Credit	12,100	25,000	30,900	35,700	41,200	144,900
Require Full Basis Adjustment	400	1,600	3,100	4,700	6,200	16,000
Eliminate Private-Purpose Tax-Exempt Bonds (REV-12)						
Addition to CBO Baseline						
Mortgage Revenue Bonds						
Multiple dwellings	100	200	300	400	600	1,600
Single-family homes	300	600	700	700	700	3,000
Industrial Development Bonds						
Small issues	100	200	200	300	300	1,100
Pollution control	100	100	200	400	500	1,300
Other	100	300	600	900	1,300	3,200

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Eliminate Private-Purpose Tax-Exempt Bonds (REV-12) (Continued)						
Addition to CBO Baseline (Continued)						
Student Loan Bonds	16	47	100	100	100	300
Hospital Bonds	200	500	1,000	1,600	2,200	5,500
Eliminate Preferences for Financial Institutions (REV-14)						
Addition to CBO Baseline						
Disallow Interest Deductions for Bank Holdings of Tax-Exempt Securities	100	300	300	300	300	1,300
Repeal the Deduction for Excess Bad-Debt Reserves	500	600	400	600	700	2,800
Treat Credit Unions Like Other Thrift Institutions	100	200	200	200	300	1,100
Repeal the 20 Percent Deduction for Taxable Income from Life Insurance Activities and the Small Life Insurance Company Deduction	1,000	1,700	1,900	2,100	2,200	8,900

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Eliminate Preferences for Financial Institutions (REV-14) (Continued)						
Addition to CBO Baseline (Continued)						
Repeal Preferences for Property and Casualty Insurance Companies	300	600	1,500	2,100	2,500	7,000
Restrict Use of the Cash Method of Accounting (REV-15)						
Addition to CBO Baseline	400	1,000	1,100	1,100	1,200	4,800
Repeal the Dividend Exclusion (REV-16)						
Addition to CBO Baseline	200	600	600	700	700	2,800
Repeal the Tax Credit for Employee Stock Ownership Plans (REV-17)						
Addition to CBO Baseline	2,100	1,400	700	500	0	4,700
Restrict Deductions for Business Entertainment and Meals (REV-23)						
Addition to CBO Baseline						
Disallow Deductions for Business Entertainment and Limit Deductions for Business Meals	500	1,100	1,400	1,700	2,100	6,700

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Restrict Deductions for Business Entertainment and Meals (REV-23) (Continued)						
Addition to CBO Baseline (Continued)						
Limit Deductions to 50 Percent for Business Entertainment and 75 Percent for Business Meals	1,700	3,200	3,800	4,400	4,900	18,100
Limit Deductions to 80 percent for Business Entertainment and Meals	1,400	2,600	3,100	3,500	3,800	14,400
Limit Interest Deductions (REV-25)						
Addition to CBO Baseline						
Limit to Mortgage Interest on a Principal Residence Plus $5,000 in Excess of Net Investment Income	300	2,100	2,300	2,400	2,600	9,700
Limit to $20,000 (Joint Returns) or $15,000 (Other) in Excess of Net Investment Income	300	2,300	2,400	2,600	2,900	10,500

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Tax Capital Gains at Death (REV-35)						
Addition to CBO Baseline	23	4,600	4,900	5,300	5,600	20,400
400 Transportation						
Withdraw Most Federal Aid for Public Works Infrastructure (NDD-01)						
Eliminate Most Aid						
Budget Authority	23,000	26,000	28,000	29,000	30,500	136,500
Outlays	8,600	17,000	20,800	23,600	25,700	95,700
Phase Out Aid						
Budget Authority	2,900	6,500	10,500	14,500	19,000	53,400
Outlays	1,100	3,300	6,900	10,700	14,900	36,900
Raise Aviation User Fees to Cover Air Traffic Control Costs (NDD-08)						
Addition to CBO Baseline	400	500	600	700	700	2,900
Establish User Fees for Certain Coast Guard Services (NDD-09)						
Budget Authority	820	830	830	840	860	4,180
Outlays	820	830	830	840	860	4,180

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
400 Transportation (Continued)						
Eliminate AMTRAK Subsidies (NDD-13)						
Budget Authority	610	640	670	690	720	3,330
Outlays	610	570	630	690	720	3,220
Reduce Federal Mass Transit Aid (NDD-14)						
Budget Authority	1,790	1,840	1,890	1,900	1,920	9,340
Outlays	720	1,030	1,280	1,490	1,690	6,210
Reduce and Refocus Highway Spending (NDD-15)						
Budget Authority	6,400	6,700	6,900	7,200	7,500	34,700
Outlays	900	3,800	4,700	5,200	5,600	20,300
450 Community and Regional Development						
Eliminate or Restrict Eligibility for Community-Development Block Grants (NDD-24)						
Terminate CDBG						
Budget Authority	2,650	3,300	3,400	3,550	3,700	16,600
Outlays	50	1,050	2,650	3,300	3,450	10,450
Restrict Eligibility and Reduce Funding						
Budget Authority	430	450	470	490	510	2,350
Outlays	10	170	410	460	480	1,500

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
450 Community and Regional Development (Continued)						
End Funding of the Economic Development Administration and Urban Development Action Grants (NDD-25)						
Terminate EDA						
Budget Authority	130	220	230	240	250	1,100
Outlays	30	90	150	200	220	690
Terminate UDAG						
Budget Authority	330	350	360	380	390	1,820
Outlays	20	110	210	280	340	970
Reduce Incentives for Building Rehabilitation (REV-10)						
Addition to CBO Baseline						
Repeal the Rehabilitation Tax Credits	400	1,300	1,800	2,100	2,400	8,000
Limit Credits to Historic Renovations	300	900	1,200	1,300	1,400	5,100
500 Education, Training, Employment and Social Services						
Reduce Guaranteed Student Loan Subsidies (ENT-21)						
Require Students to Pay In-School Interest						
Budget Authority	-95	560	970	1,200	1,300	3,950
Outlays	-50	390	870	1,150	1,300	3,650

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services (Continued)						
Reduce Guaranteed Student Loan Subsidies (ENT-21) (Continued)						
Raise Students' Interest Rates After Leaving School						
Budget Authority	--	20	85	150	200	450
Outlays	--	15	65	140	190	400
Reduce Lenders' Subsidies by One-half Percentage Point						
Budget Authority	25	70	120	160	200	560
Outlays	15	60	100	150	190	510
Reduce Default Costs						
Budget Authority	--	25	110	160	180	470
Outlays	--	25	110	160	180	470
Reduce and Retarget Aid for Dependent Care (ENT-23)						
Gross Revenue Gain	200	1,700	1,900	2,100	2,300	8,200
Outlays	-100	-850	-950	-1,050	-1,150	-4,100
Net Savings	100	850	950	1,050	1,150	4,100
Eliminate Funding for Untargeted Elementary and Secondary Education Programs (NDD-26)						
Eliminate Chapter 2 Block Grant						
Budget Authority	540	570	600	640	680	3,000
Outlays	45	410	560	600	630	2,250

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services (Continued)						
Eliminate Funding for Untargeted Elementary and Secondary Education Programs (NDD-26) (Continued)						
Eliminate Untargeted Portion of Vocational Education						
Budget Authority	400	420	450	470	500	2,250
Outlays	10	320	420	440	470	1,650
Eliminate Mathematics and Science Education						
Budget Authority	45	50	50	55	60	260
Outlays	5	30	45	50	55	190
Increase Pell Grant Targeting (NDD-27)						
Budget Authority	360	380	410	430	460	2,050
Outlays	75	360	390	410	440	1,650
Reduce Campus-Based Student Aid (NDD-28)						
Budget Authority	240	260	270	290	310	1,350
Outlays	25	240	260	270	290	1,100
Reduce Funding for the Job Training Partnership Act (NDD-29)						
Budget Authority	420	590	770	960	1,170	3,910
Outlays	220	390	550	730	930	2,820

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
550 Health						
Tax Employer-Paid Health Insurance (ENT-01)						
Tax Some Employer-Paid Health Insurance						
Income Tax	2,500	4,200	5,200	6,400	7,700	26,000
Payroll Tax	1,000	1,700	2,100	2,500	3,000	10,300
Tax Employer-Paid Health Insurance But Allow a Credit for Employer and Employee Contributions						
Income Tax	-100	700	1,100	1,500	1,800	5,000
Payroll Tax	7,100	10,100	11,300	12,500	13,800	54,800
Limit Payments for Long-Term Care Services (ENT-11)						
Budget Authority	750	870	990	1,100	1,250	4,960
Outlays	750	870	990	1,100	1,250	4,960
Modify the Federal Employees Health Benefits Program (PERS-06)						
Budget Authority	60	120	190	270	360	1,000
Outlays	60	120	190	270	360	1,000
570 Medicare						
Reduce Medicare's Payments for Indirect Medical Education Costs (ENT-02)						
Outlays	780	1,000	1,100	1,250	1,350	5,480

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
570 Medicare (Continued)						
Reduce Reimbursements for Capital Expenditures Under Medicare (ENT-03)						
Move Immediately to a Prospective Reimbursement System						
Outlays	220	450	700	960	1,270	3,600
Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	490	790	1,120	1,420	1,780	5,600
Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	20	100	370	800	1,310	2,600
Reduce Medicare's Payments to Hospitals for Direct Medical Education Expenses (ENT-04)						
Outlays	100	190	270	350	440	1,350
Increase the Hospital Insurance Payroll Tax (ENT-05)						
Addition to CBO Baseline	7,400	10,200	10,900	11,800	12,800	53,100
Adopt a Fee Schedule for Reimbursing Physicians Under Medicare (ENT-06)						
Fee Schedule with Rates Updated Annually by the MEI						
Budget Authority	--	150	270	370	500	1,290
Outlays	--	130	250	340	460	1,180

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
570 Medicare (Continued)						
Adopt a Fee Schedule for Reimbursing Physicians Under Medicare (ENT-06) (Continued)						
Fee Schedule with Spending Cap Set by the MEI						
Budget Authority	--	720	1,500	2,440	3,590	8,250
Outlays	--	570	1,310	2,200	3,240	7,320
Fee Schedule with Spending Cap Set by Growth in GNP						
Budget Authority	--	160	300	480	760	1,700
Outlays	--	130	260	430	670	1,490
Increase Medicare's Premium for Physicians' Services (ENT-07)						
Budget Authority	970	1,350	1,430	1,525	1,620	6,895
Outlays	970	1,350	1,430	1,525	1,620	6,895
Use the Tax System to Impose a Supplementary Income-Related Premium for Physicians' Services (ENT-08)						
Addition to CBO Baseline	500	1,900	2,000	2,100	2,300	8,800
Tax a Portion of Medicare Benefits (ENT-09)						
Addition to CBO Baseline						
With Income Threshold	800	2,900	3,500	4,300	5,300	16,800

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
570 Medicare (Continued)						
Tax a Portion of Medicare Benefits (ENT-09) (Continued)						
Addition to CBO Baseline (Continued)						
Without Income Threshold	1,500	5,100	6,000	7,000	8,200	27,800
Increase Medicare's Deductible for Physician Services (ENT-10)						
Budget Authority	720	1,130	1,340	1,535	1,695	6,420
Outlays	620	1,070	1,280	1,480	1,630	6,080
600 Income Security						
Require a Two-Week Waiting Period for Unemployment Insurance Benefits (ENT-19)						
Budget Authority	--	--	--	--	--	--
Outlays	--	930	970	980	1,020	3,900
Index the Unemployment Insurance Taxable Wage Base (ENT-20)						
Addition to CBO Baseline	--	300	700	1,000	800	2,800

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
600 Income Security (Continued)						
Reduce the Subsidy for Nonpoor Children in Child Nutrition Programs (ENT-22)						
Budget Authority	280	300	320	330	350	1,580
Outlays	250	290	310	330	350	1,550
Reduce Subsidies for Low-Income Assisted Housing (NDD-23)						
Moratorium on Additional Commitments						
Budget Authority	7,700	0	0	0	0	7,700
Outlays	160	460	690	850	930	3,100
One-Year Freeze of Rents						
Budget Authority	200	210	220	230	240	1,100
Outlays	290	310	350	390	420	1,750
Eliminate COLAs for Federal Retirees Under Age 62 (PERS-02)						
Military Retirement						
Savings from CBO Baseline	270	750	1,230	1,730	2,220	6,200
Civilian Retirement						
Savings from CBO Baseline	90	200	220	220	200	930

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
600 Income Security (Continued)						
Reduce Civil Service Retirement Benefits (PERS-03)						
Budget Authority	0	60	130	180	220	590
Outlays	100	240	300	380	460	1,480
Establish Supplemental Federal Retirement Benefits for New Workers (PERS-04)						
S. 1527						
Savings from CBO Baseline	130	240	300	340	350	1,360
H.R. 3660						
Savings from CBO Baseline	280	430	540	650	790	2,690
Repeal 401(k) Plans or Lower the Maximum Contribution (REV-18)						
Addition to CBO Baseline						
Repeal 401(k) Plans	1,900	4,200	4,900	5,900	7,000	23,800
Limit Contributions to $7,000 per year	700	1,400	1,400	1,600	1,900	7,000

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
600 Income Security (Continued)						
Decrease Maximum Limits on Pension Contributions and Pension Benefits (REV-19)						
Addition to CBO Baseline						
Decrease Limits to $60,000 and $15,000	600	1,700	1,900	2,200	2,400	8,700
Repeal Three-Year Basis Recovery Rule for Contributory Retirement Plans (REV-20)						
Addition to CBO Baseline	800	2,200	2,800	2,900	2,900	11,600
Tax a Portion of Nonretirement Fringe Benefits (REV-21)						
Addition to CBO Baseline						
Tax Life Insurance Premiums						
Income tax	1,500	2,300	2,400	2,500	2,600	11,300
Payroll tax	500	600	700	700	800	3,300
Disallow "Cafeteria" Plans						
Income tax	600	1,600	2,300	3,000	3,700	11,200
Payroll tax	200	700	1,000	1,400	1,700	5,000

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
600 Income Security (Continued)						
Eliminate Extra Tax Exemption for the Elderly and the Blind (REV-28)						
Addition to CBO Baseline	1,700	3,500	3,800	4,300	4,600	17,900
650 Social Security						
Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs (ENT-12)						
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	5,250	7,200	7,300	7,250	7,100	34,100
Other Non-Means-Tested Programs	1,350	1,850	1,900	1,950	2,000	9,050
Offsets in Means-Tested Programs	-880	-1,300	-1,350	-1,450	-1,500	-6,500
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Social Security/ Railroad Retirement	1,700	4,750	8,250	11,900	15,550	42,150

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
650 Social Security (Continued)						
Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs (ENT-12) (Continued)						
Limit COLAs to Two-Thirds of CPI Increase for Five Years (Continued)						
Other Non-Means-Tested Programs	440	1,200	2,100	3,050	4,000	10,800
Offsets in Means-Tested Programs	-50	-200	-380	-560	-800	-2,000
Limit COLAs to CPI Increase Minus 2 Percentage Points for Five Years						
Social Security/ Railroad Retirement	3,100	7,450	12,050	16,850	21,850	61,300
Other Non-Means-Tested Programs	800	1,900	3,100	4,350	5,650	15,750
Offsets in Means-Tested Programs	-90	-320	-570	-820	-1,150	-2,950
Pay Full COLA on Benefits Below a Certain Level and 50 Percent of COLA on Amounts Exceeding That Level						
Social Security/ Railroad Retirement	590	1,650	2,800	3,950	5,150	14,150

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
650 Social Security (Continued)						
Limit the Increase in the Social Security "Bend Points" (ENT-13)						
Outlays	10	70	175	350	600	1,205
Reduce the Replacement Rate Within Each Bracket of the Social Security Benefit Formula (ENT-14)						
Outlays	65	260	480	750	1,100	2,655
Lengthen the Social Security Benefit Computation Period by Three Years (ENT-15)						
Outlays	25	100	300	500	700	1,625
Eliminate Social Security Benefits for Children of Retirees Aged 62-64 (ENT-16)						
Outlays	40	180	350	590	650	1,810
Cover All Newly Hired State and Local Government Workers Under Social Security and Medicare (ENT-17)						
Addition to CBO Baseline	200	1,000	1,700	2,600	3,500	9,100

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
650 Social Security (Continued)						
Increase Taxation of Non-Means-Tested Entitlement Benefits (REV-27)						
Addition to CBO Baseline						
Increase Taxation of Social Security and Railroad Retirement Tier I						
Tax 50 percent of benefits	2,200	7,500	7,900	8,300	8,800	34,700
Tax 85 percent of benefits	5,300	17,900	19,100	20,300	21,500	84,100
Tax All Unemployment Compensation	300	800	800	800	800	3,500
Tax Workers' Compensation and Black Lung Benefits	800	2,800	3,100	3,400	3,800	14,000
700 Veterans' Benefits and Services						
Eliminate Veterans' Compensation Payments for Those With Low-Rated Disabilities (ENT-18)						
Budget Authority	2,150	2,250	2,350	2,400	2,500	11,650
Outlays	2,000	2,250	2,300	2,400	2,500	11,450

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
700 Veterans' Benefits and Services (Continued)						
Convert Underused Acute-Care Beds in VA Hospitals (NDD-31)						
Budget Authority	75	130	190	260	300	950
Outlays	85	120	190	250	310	950
Require Cost Sharing for VA Hospital Care (NDD-32)						
Budget Authority	170	310	340	370	400	1,590
Outlays	170	310	340	370	400	1,590
Limit Eligibility for VA Hospital Care to Service-Disabled and Poor Veterans (NDD-33)						
Budget Authority	670	1,050	1,150	1,250	1,400	5,520
Outlays	560	870	940	1,000	1,100	4,470
750 Administration of Justice						
End Funding for the Legal Services Corporation (NDD-20)						
Budget Authority	310	330	350	370	390	1,750
Outlays	270	320	340	370	390	1,690

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
850 General Purpose Fiscal Assistance						
Terminate General Revenue Sharing (ENT-24)						
Budget Authority	4,550	4,550	4,600	4,600	4,600	22,900
Outlays	3,350	4,550	4,600	4,600	4,600	21,700
Eliminate State and Local Tax Deductibility (REV-24)						
Addition to CBO Baseline						
Eliminate Deductibility of State and Local Taxes						
Income taxes	3,400	23,300	25,200	27,300	29,500	108,700
Sales taxes	800	5,200	5,700	6,300	6,900	25,000
Property taxes	1,800	12,000	13,200	14,500	15,900	57,300
Maintain Deductibility of Taxes Above Floor of 1 Percent of AGI	800	5,200	5,600	6,000	6,400	24,000
All Functions						
Scale Back Nondefense Construction Projects (NDD-04)						
Budget Authority	2,200	1,750	1,750	1,800	2,000	9,500
Outlays	800	1,550	1,850	1,950	2,050	8,200

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
All Functions (Continued)						
Modify the Davis-Bacon Act by Raising the Contract Threshold and Allowing Unrestricted Use of Helpers (NDD-30)						
Budget Authority	590	620	640	670	700	3,220
Outlays	110	330	450	520	560	1,970
Cap Pay Adjustments for Federal Civilian Employees (PERS-01)						
Budget Authority	800	2,230	3,390	4,500	5,890	16,810
Outlays	820	2,270	3,460	4,580	5,980	17,110
Require the Postal Service to Pay the Full Cost of Retirement and Other Benefits (PERS-05)						
Budget Authority	--	--	-460	-660	-350	-1,470
Outlays	--	--	1,100	1,350	1,550	4,000
Reduce Federal Travel Expenses (PERS-07)						
Budget Authority	580	610	650	690	730	3,260
Outlays	530	560	600	630	670	2,990

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Options Not Assignable to a Function						
Eliminate Federal Subsidies to Business (NDD-03)						
Budget Authority	1,900	3,500	3,300	3,900	4,300	17,000
Outlays	1,100	2,900	3,900	4,600	5,000	17,500
Raise Marginal Tax Rates for Individuals (REV-01)						
Addition to CBO Baseline						
Raise Marginal Tax Rates 5 Percent	13,300	19,100	20,600	22,100	23,800	98,900
Raise Marginal Tax Rates 10 Percent	26,700	38,400	41,300	44,400	47,700	198,500
Amend or Repeal Indexing of Income Tax Rates (REV-02)						
Addition to CBO Baseline						
Repeal Indexing	4,400	12,700	23,600	36,700	51,900	129,300
Delay Further Indexing Until January 1, 1988	4,400	7,300	7,800	8,500	9,100	37,100
Index for Inflation in Excess of 3 Percent	3,800	10,400	18,100	27,000	37,400	96,700

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Impose a Corporate Surtax (REV-03)						
Addition to CBO Baseline						
Surtax on Tax before Credits						
10 Percent	7,800	13,900	15,100	15,800	16,100	68,800
5 Percent	3,900	6,900	7,500	7,800	7,900	33,900
Surtax on After-Tax Economic Income						
5 Percent	10,800	18,300	20,700	23,300	24,900	97,900
2.5 Percent	5,400	8,800	10,000	11,300	12,100	47,600
Impose a Value-Added or National Sales Tax (REV-04)						
Addition to CBO Baseline						
5 Percent Tax, Comprehensive Base	0	71,200	107,700	115,800	124,800	419,500
5 Percent Tax, Narrower Base, Exemptions for Food, Housing, and Medical Care	0	42,400	64,100	69,000	74,300	249,800
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Means-Tested Programs	0	56,000	84,900	91,200	98,100	330,200

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Increase Excise Taxes (REV-06)						
Addition to CBO Baseline						
Extend DEFRA Increase of Telephone Excise Tax	0	1,300	2,300	2,500	2,700	8,800
Raise the Cigarette Excise Tax to 32 Cents per Pack	3,500	5,100	5,100	5,100	5,100	23,800
Increase Excise Taxes on Distilled Spirits	500	700	700	700	700	3,500
Raise Excise Taxes on Beer and Wine to Rate on Distilled Spirits	5,700	6,200	6,300	6,400	6,500	31,100
Index Current Cigarette and Alcohol Excise Tax Rates for Inflation	300	400	600	800	1,100	3,200

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Combine Miscellaneous Deductions and Employee Business Expense Deductions and Subject to a Floor of 1 Percent of AGI (REV-26)						
Addition to CBO Baseline						
Treat Combined Deduction as an Adjustment to Income	300	2,100	2,300	2,500	2,700	9,900
Treatment Combined Deduction as an Itemized Deduction	500	3,700	4,000	4,300	4,600	17,100
Disallow Income Averaging for Former Students (REV-29)						
Addition to CBO Baseline	100	500	600	600	700	2,500
Improve Tax Compliance and Enforcement (REV-30)						
Addition to CBO Baseline						
Increase IRS Audit Coverage	300	600	800	900	1,000	3,600
Increase Penalties for Failure to Comply with Tax Laws	400	400	400	400	400	1,900

SUMMARY TABLE (Continued)

Budget Function Options	1987	1988	1989	1990	1991	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Reduce Tax Preferences Across the Board (REV-31)						
Addition to CBO Baseline	900	37,000	44,000	50,000	57,000	197,000
Expand Minimum Taxes (REV-32)						
Addition to CBO Baseline						
Expand Existing Individual Alternative Minimum Tax						
Option I						
at 20 percent	100	300	300	300	400	1,100
at 25 percent	1,400	7,100	8,700	10,700	13,200	41,100
Option II						
at 25 percent	900	5,000	6,000	5,500	4,900	22,300
Expand Base of Present Corporate Add-on Minimum Tax						
at 15 percent	1,000	3,300	5,400	8,500	13,400	31,700
at 20 percent	1,400	4,600	7,300	11,600	18,100	43,000
Replace Add-on Corporate Tax with a Broad-Based Alternative Minimum Tax						
at 15 percent	700	1,400	2,000	2,900	4,300	11,300
at 20 percent	1,100	2,200	3,200	4,600	6,700	17,800
at 25 percent	2,100	4,100	5,400	7,200	9,600	28,400

**CONGRESSIONAL
BUDGET OFFICE**
**Second and D Streets, S.W.
Washington, D.C. 20515**

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

FIRST-CLASS MAIL
POSTAGE & FEES PAID
C.B.O.
PERMIT No. G-70